

JOURNAL OF ACCOUNTANCY

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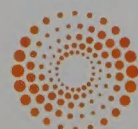
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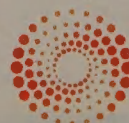
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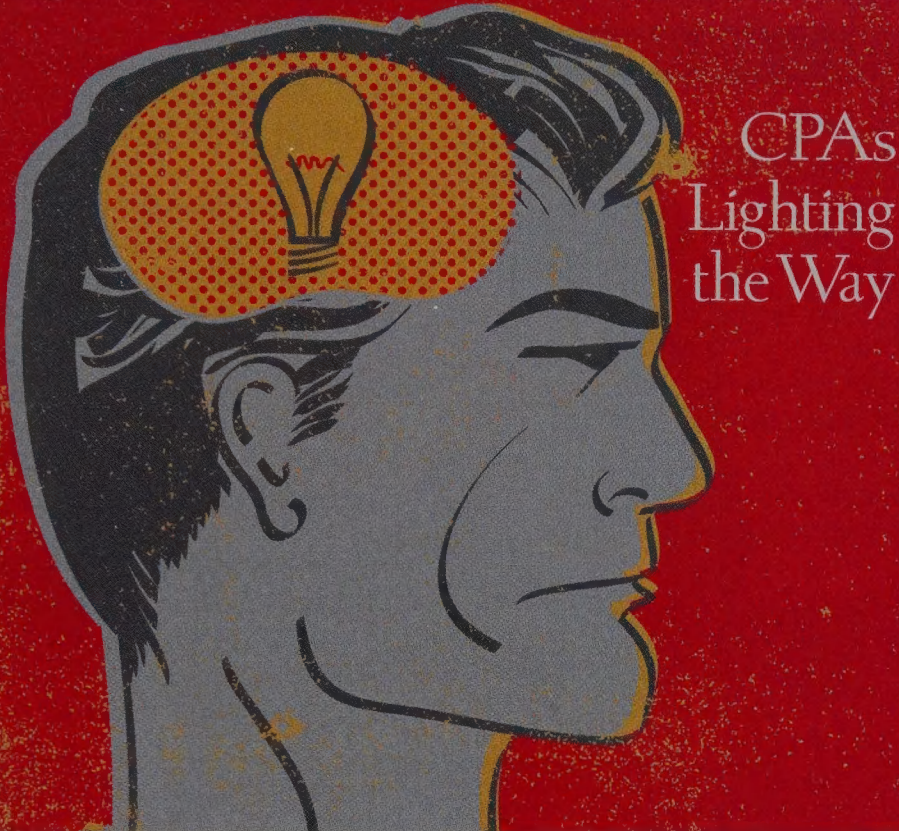


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CPAs
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42 | AUDITING Component Materiality for Group Audits

by Steven M. Glover, Douglas F. Prawitt, Jonathan T. Liljegren and William F. Messier Jr.
Regulatory inspections and firm quality reviews have identified potentially troubling practices used by firms for establishing component level materiality for group audits. Current standards lack sufficient guidance on the topic. This article offers one approach to establishing and evaluating component materiality.

► For CPAs who audit consolidated or group financial statements

48 | BUSINESS & INDUSTRY Forecasting Post-Combination Earnings

by Michael S. Devine

A company planning an acquisition should consider using an acquisition accounting forecast for a business combination to estimate the total effect on post-acquisition earnings under Statement no. 141(R).

► For CPAs in business and industry

54 | BUSINESS & INDUSTRY Managing Customer Profitability

by Marc J. Epstein, Michael Friedl and Kristi Yuthas

Companies recognize that to achieve a competitive advantage, they must be customer-focused. A large and growing body of evidence indicates that most companies have some highly profitable customers and other enormously unprofitable ones. The recognition of differences in customer profitability by senior financial managers and the use of available tools are critical to a firm's ability to derive value from its customer investments.

► For CPA financial managers

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Test-Driving the Codification

by Caroline O. Ford and C. William Thomas
FASB's Accounting Standards Codification was designed to simplify the classification of accounting standards by restructuring all authoritative U.S. GAAP for nongovernmental entities into one Web-accessible database under a common referencing system. The authors offer a detailed look at the structure of the codification and compare the results of research using the new system with those of traditional research methods.

► For all CPAs

76 | BUSINESS & INDUSTRY

States Bite Into Broken Gift Cards

by Charles Owen Kile Jr. and Patricia S. Wall
As gift cards continue to play an important role in holiday retail sales, financial reporting and business law experts examine the obligations of retailers under state escheat laws for unredeemed gift card balances.

► For CPAs in business and industry, and auditors



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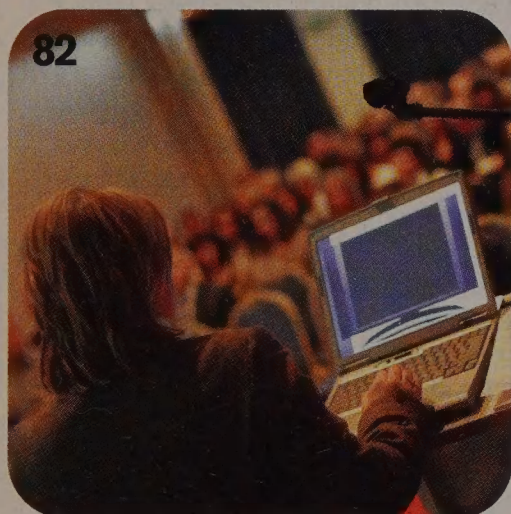
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On the Verge of an Academic Revolution

by Kim Nilsen

For those charged with educating the next generation of CPAs, the expected shift from U.S. GAAP to IFRS stirs up a host of issues. Hear what eight prominent academics had to say about how IFRS will affect accounting education.

► For all CPAs



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Highlights of Accounting Systems Research

by Cynthia Bolt-Lee and Janette Moody

Summaries of accounting information systems research articles yield insights for practitioners into achievable benefits and pitfalls to avoid in accounting and IT system implementations.

► For CPAs in business and industry

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by Stanley Zarowin

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- **Recommendations
From the 2008 CPA
Examination Summit**
The event—organized by Howard University's Center for Accounting Education and the National Association of Black Accountants—focused on exploring strategies for increasing the number of African Americans sitting for and passing the CPA exam.

AICPA CONFERENCES Coverage From Washington, D.C.

- News and highlights from the AICPA National Conference on Current SEC and PCAOB Developments and the AICPA National Conference on Banks & Savings Institutions.

ARTICLE

- **Economic Outlook**
Results of the fourth quarter AICPA/UNC Kenan-Flagler Business and Industry Economic Outlook Survey. The survey, conducted after the Nov. 4 elections, asked CFOs, controllers, CEOs and COOs for their take on prospects for their own companies and the larger economy.

AUDIO

- **IFRS and Accounting
Education Sound
Bites**
Listen to bonus content from the eight distinguished academics who participated in the *JofA*'s virtual round table (see "On the Verge of an Academic Revolution," page 82).

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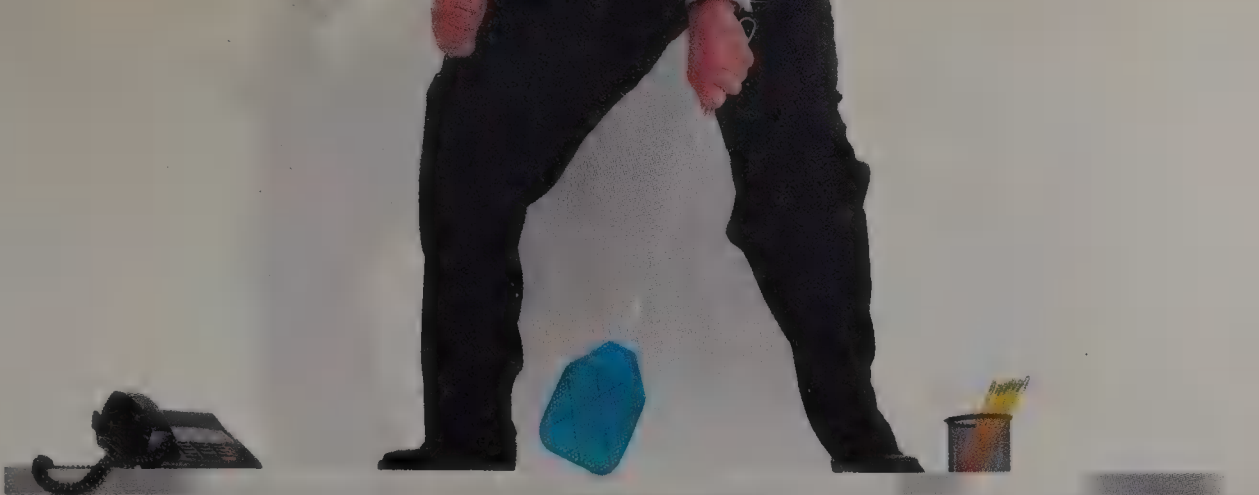
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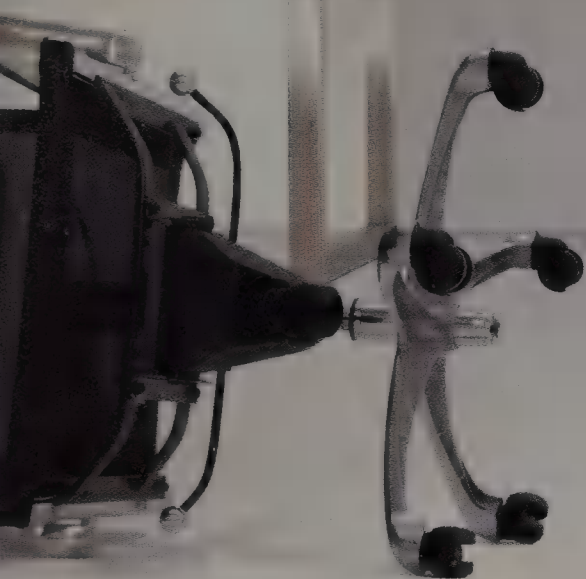


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■ Component Materiality for Group Audits page 42



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■ Managing Customer Profitability page 54



Marc J. Epstein is distinguished research professor of management at Jones Graduate School of Management at Rice University in Houston. Formerly a professor at Harvard Business School, Stanford Business School and INSEAD (European Institute of Business Administration), he has written management accounting guidelines and more than 100 articles and 15 books.




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Kristi Yuthas is the information systems management chair at Portland State University. She has a background in IT consulting, focusing primarily on business process improvement and knowledge management. Her research explores the strategic, organizational and social consequences of management, accounting and marketing information systems.

(Continued on page 16)

A man in a dark suit is running through a field of tall, dry grass, reaching out to catch a flag that is flying in the air. In the background, a large wind turbine stands against a cloudy sky. A red, wavy banner is superimposed over the lower part of the image, containing the text.

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(Continued from page 14)

■ Test-Driving the Codification page 62



Caroline O. Ford, CPA, Ph.D., is an assistant professor of accounting at Baylor University. She specializes in behavioral accounting research. Her research includes the behavioral implications associated with financial accounting topics. Prior to joining the Baylor faculty, she worked as a project accountant for Lincoln Property Co. in Dallas and served as an accounting instructor at East Texas Baptist University.



C. William Thomas, CPA, Ph.D., has been a member of the faculty of Baylor University for 35 years. He chaired the Department of Accounting in the Hankamer School of Business from 1983 to 1995. He holds the KPMG/Thomas L. Holton Chair and J.E. Bush Professorship in accounting and has been appointed a master teacher. His areas of interest in teaching and research include financial accounting, auditing and taxation.

■ States Bite Into Broken Gift Cards page 76



Charles Owen Kile Jr., Ph.D., is an assistant professor of accounting at Middle Tennessee State University in Murfreesboro, Tenn. He received his M.S. and Ph.D. in accounting from Washington University in St. Louis. Since that time, he has remained active in research and teaching. He has published articles in a variety of academic and practitioner journals and has served on the faculty at Washington University, Emory University and the University of Alabama–Huntsville. He has also conducted research projects for the SEC, Deloitte and the Department of Defense, as well as volunteer work for nonprofit organizations.



Patricia S. Wall, J.D., CPA, MBA, Ed.D., is an assistant professor of business law at Middle Tennessee State University in Murfreesboro, Tenn. She received her J.D. in 1979 from the University of Tennessee College of Law and her MBA in 1987 from the University of Tennessee–Chattanooga, and her Ed.D. in 2004 from Tennessee State University.

■ On the Verge of an Academic Revolution page 82



Kim Nilsen is editorial director for the *Journal of Accountancy* and oversees the *JofA*'s coverage of public accounting and auditing. She has more than 15 years of experience in journalism and publishing, including nearly seven years with American City Business Journals.

■ Highlights of Accounting Systems Research page 86



Cynthia Bolt-Lee, CPA, M. Taxation, is an associate professor at The Citadel School of Business Administration in Charleston, S.C., where she teaches taxation, auditing and introductory accounting. She has worked eight years in tax and audit practice for international and local firms. Her research interests include tax ethics, accounting education, practitioners' use of research, and innovative instructional strategies.



Janette Moody, CPA, Ph.D., is a professor at The Citadel School of Business Administration. She joined The Citadel faculty in 1993, where she teaches management information systems and accounting information systems in the undergraduate and MBA programs. She has worked in public accounting and for major corporations. She has published numerous articles in academic journals, including *MIS Quarterly*, *Expert Systems with Applications* and *Journal of Management Information Systems*. She is a frequent presenter at national and international conferences.

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HIGHLIGHTS

■ **The SEC released preliminary details on its study on “mark-to-market” accounting, as authorized in October by section 133 of the Emergency Economic Stabilization Act of 2008 (EESA).** The study is to be completed by Jan. 2 in consultation with the Treasury secretary and the Board of Governors of the Federal Reserve System. Under the terms of the EESA, the study will focus on:

- The effects of such accounting standards on a financial institution’s balance sheet.
- The impacts of such accounting on bank failures in 2008.
- The impact of such standards on the quality of financial information available to investors.
- The process used by FASB in developing accounting standards.
- The advisability and feasibility of modifications to such standards.
- Alternative accounting standards to those provided in FASB Statement no. 157, *Fair Value Measurements*.

For more information on the study, visit www.sec.gov/spotlight/fairvalue.htm.

■ **In response to the global financial crisis, the International Accounting Standards Board (IASB) amended two of its standards to more closely align with U.S. GAAP.** The amendments to IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Instruments: Disclosures*, permit the reclassification of some financial instruments. The amendments to IAS 39 introduce the possibility of reclassifications for companies applying International Financial Reporting Standards (IFRS), which were already permitted under U.S. GAAP in rare circumstances. Companies can implement the reclassification amendments to IFRS from July 1, 2008.

The European Union (EU) adopted the IASB’s amendments to IAS 39 and IFRS 7 on Oct. 15, just two days after their release by the IASB. To view the EU regulation, visit <http://tinyurl.com/55dakw>.

In addition, the IASB said it would undertake the following:

- Continue to ensure that any IFRS guidance on fair value measurement of financial instruments in markets that are no longer active is consistent with U.S. GAAP.
- Work closely with FASB to develop a common approach to issues related to the valuation of financial assets and liabilities resulting from purchases made through the U.S. Emergency Economic Stabilization Act of 2008 and any other similar programs internationally, if and when these programs are implemented.

For more information about the IASB’s response to the credit crisis, see www.iasb.org/credit+crisis.htm.

■ **The Treasury Department outlined details of its plan to purchase up to \$250 billion of senior preferred shares in financial institutions.** Under the Capital Purchase Program, the minimum subscription amount available to a participating institution is 1% of risk-weighted assets, while the maximum is the lesser of \$25 billion or 3% of risk-weighted assets.

The senior preferred shares will qualify as Tier 1 capital, will rank senior to common stock, will pay a cumulative dividend of 5% annually for the first five years, and will reset to an annual rate of 9% after year five. The shares will be nonvoting, other than class voting rights on matters that could adversely affect the shares.

The shares will be callable at par after three years. The Treasury Department can also transfer the senior preferred shares to

a third party at any time. In conjunction with the purchase of senior preferred shares, the Treasury Department will receive warrants to purchase common stock with an aggregate market price equal to 15% of the senior preferred investment.

Companies participating in the program must adopt the Treasury Department’s standards for executive compensation and corporate governance for the period during which the department holds equity issued under the program. These standards generally apply to the CEO, CFO and the next three most highly compensated executive officers. Participants must meet certain standards regarding senior executive compensation, including the requirement of a clawback of any bonus or incentive compensation paid based on inaccurate statements and prohibitions against golden parachutes.

The program is available to qualifying U.S.-controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities that elected to participate by Nov. 14. The Treasury Department will fund the senior preferred shares purchased under the program by the end of 2008 after consultation with the appropriate federal banking agency. A term sheet is available at <http://tinyurl.com/5yh6s>.

■ **The Department of the Treasury’s Advisory Committee on the Auditing Profession voted to approve a slate of more than 30 recommendations for enhancing the profession’s sustainability.** The committee’s work marked the first major study of the public company auditing profession since the passage of the Sarbanes-Oxley Act in 2002. AICPA President and CEO Barry Melancon was a member of the advisory committee, along with 20 other business and academic thought leaders.

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The recommendations were contained in three sections. The human capital recommendations include:

- Implement market-driven curricula and content for accounting students.
- Improve the representation and retention of minorities in the auditing profession by, among other things, recruiting minorities from other disciplines and careers, and emphasizing the role of community colleges as a career starting point.
- Ensure a supply of qualified financial accounting, audit and tax faculty to meet demand for the future.
- Develop and maintain consistent demographic and higher education program profile data.
- Encourage the AICPA and the American Accounting Association to form a commission to provide a study of the possible future structure of higher education for the accounting profession.

The recommendations on firm structure and finances include:

- Urge the PCAOB and the SEC, in conjunction with other stakeholders, to explore the feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards to improve governance and transparency at public company auditing firms.
- Urge the SEC and Congress to provide for the PCAOB's creation of a national center focused on fraud prevention and detection experiences, practices, methodologies and technologies and commissioning research and other fact-finding.
- Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the profession and financial reporting. That includes encouraging states to substantially adopt the mobility provisions of the Uniform Accountancy Act by stating that if states have failed to adopt the mobility provisions of the UAA by Dec. 31,

2010, Congress should pass a federal provision requiring those states to adopt these provisions.

- Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients.
- Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.
- Urge the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report.
- Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating information required by the EU's Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB and key indicators of audit quality and effectiveness as determined by the PCAOB. Further, urge the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.

The recommendations on firm concentration and competition include:

- Promote the growth of smaller auditing firms. The recommendation includes requiring disclosure by public companies in proxy reports of any provisions in material agreements with third parties limiting auditor choice.
- Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.
- Recommend the PCAOB, in consultation with other stakeholders, determine the feasibility of developing key indicators of audit quality

and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.

- Promote compliance with auditor independence requirements by, among other steps, compiling the SEC and PCAOB independence requirements into one document and making it accessible online.
- Adopt annual shareholder ratification of public company auditors by all public companies.
- Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts.

More information about the recommendations is available at www.treas.gov/offices/domestic-finance/acap/.

■ **FASB and the IASB published for public comment a discussion paper on financial statement presentation.** The paper, *Preliminary Views on Financial Statement Presentation*, contains an analysis of issues in financial statement presentation and presents the boards' initial thinking on addressing those issues.

International Financial Reporting Standards and U.S. GAAP provide only limited presentation guidance. In addition, presentation guidelines in GAAP are dispersed across standards. (See "Shaking Up Financial Statement Presentation," *JofA*, Nov. 08, page 56.) To address these issues, as part of their joint project on financial statements, the boards propose to introduce cohesiveness and disaggregation as the two main objectives for financial statement presentation and have developed a principles-based format to achieve that goal. Cohesiveness would ensure that a user can follow the flow of information through the different statements of an entity; disaggregation would ensure that items that respond differently to economic events are shown separately.

"The credit crisis has highlighted the need for clear presentation of financial information that is often complex," IASB Chairman Sir David Tweedie said in a press

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release. The paper is available in the "Open for Comment" section of www.iasb.org or at www.fasb.org/draft/index.shtml. Comments are due April 14, 2009.

■ **FASB issued exposure drafts of proposed statements on going concern and subsequent events.** The proposals converge U.S. GAAP and IFRS and incorporate accounting guidance related to determining the viability of entities.

The proposed statement on *Going Concern*, available at www.fasb.org/draft/ed_going_concern.pdf, would require management to consider all available information about the future when assessing whether a going concern assumption is appropriate. The time horizon is defined as at least, but not limited to, 12 months from the end of the reporting period, rather than the current limit of one year beyond the date of the financial statements. The proposal also would require disclosures when there is substantial doubt about an entity's

ability to continue as a going concern. The guidance originated as auditing standards. FASB believes the guidance belongs in the accounting literature because it is management's responsibility to assess the ongoing viability of the reporting entity, according to a FASB press release.

The proposed statement on *Subsequent Events*, available at www.fasb.org/draft/ed_subsequent_events.pdf, establishes general accounting and disclosure standards for events that occur subsequent to the balance sheet due date but before financial statements are issued or available to be issued. The proposed statement also would require disclosure of the date through which management has evaluated subsequent events, which would alert financial statement users that management has not evaluated subsequent events after that date. Comments are due by Dec. 8.

■ **GASB released a fact sheet to explain its project to develop service**

efforts and accomplishments (SEA) reporting by governments. According to the GASB release, *Basic Facts about Service Efforts and Accomplishments Reporting*, the public reporting of key service performance indicators provides decision-useful information about the government's actual accomplishments in pursuit of its goals and objectives.

The board says SEA performance information is necessary to explain the efficiency and effectiveness of government services. The Financial Accounting Foundation, which oversees GASB and FASB, declared in November 2006 that SEA reporting should be included within "general purpose financial reporting."

GASB is reviewing public comments received on a proposed update to Concepts Statement no. 2, *Service Efforts and Accomplishments Reporting*. More information on the SEA reporting project is available at www.gasb.org and www.seagov.org. ♦

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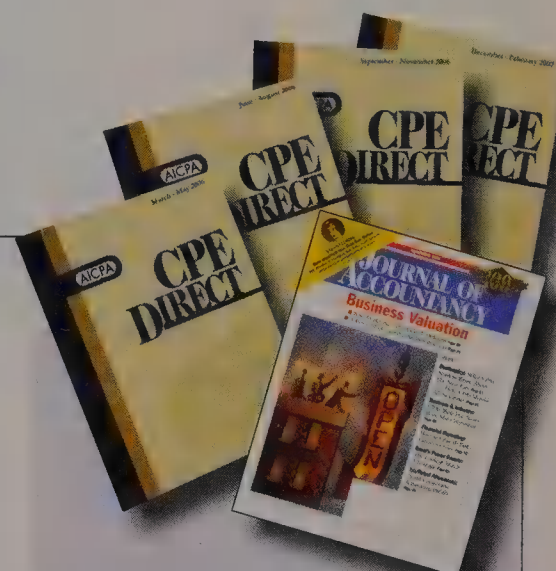
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[†]CPE Requirements and Credits

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LETTERS

NOT ALL PLANS ABUSIVE

The article in the September issue of the *JofA* by Lance Wallach, CLU, ("Abusive Insurance and Retirement Plans," page 34) sounding the alarm against the use of 419(e) plans inaccurately analyzes an October 2007 revenue ruling and two IRS notices.

Mr. Wallach accurately reports that Notice 2007-83 "identified *certain* trust arrangements involving cash-value life insurance policies...as listed transactions." In the next sentence he accurately states, "[Notice 2007-84] similarly warned against *certain* post-retirement medical and life insurance benefit arrangements" (emphasis added). But two half-truths do not a whole truth make. The juxtaposition of these sentences makes it seem as if post-retirement medical benefit plans are listed transactions. They are not. In fact, Notice 2007-84 generally praised such plans that are organized and operated properly, which Mr. Wallach fails to mention. He also fails to mention, but implies otherwise, that the Service never prohibited in Notice 2007-84 or elsewhere the use of life insurance as a funding mechanism for such plans.

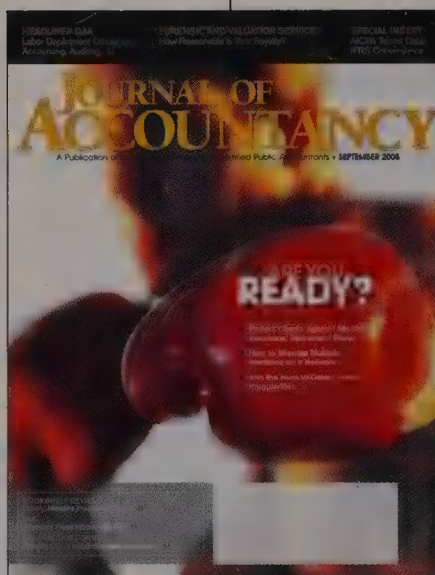
Mr. Wallach also implies in his discussion of Revenue Ruling 2007-65 that the denial of deductions under section 264(a) applies to all welfare benefit plans and all benefits. This is not true. Sections 419 and 419A calculate permissible deductions in two ways. One uses qualified direct cost (QDC), which governs the calculation of deductions for contributions for preretirement death benefits. The other uses qualified asset accounts (QAAs), which govern the calculation of deductions for contributions for, among other things, post-retirement medical and death benefits.

Revenue Ruling 2007-65 addresses only QDC. The Service does not—and cannot, based on current law, precedent or legislative history—apply section 264(a) to the calculation of QAA. By referring only to QDC, Mr. Wallach tells only half of this complicated story, potentially misleading readers who do not specialize in welfare benefit plans. Plans offering post-retirement medical benefits can be funded with cash-value life insurance, and the contributions can be deducted, notwithstanding the Service's novel and unprecedented application of section 264(a) to QDC and preretirement death benefits.

There is no question that there are abusive 419(e) plans and

abusive VEBA plans that should be shut down. But that does not make all plans abusive. Better advice within your pages would not only caution readers about such plans but also educate them on how to identify compliant ones. Half the story does not educate; it just frightens CPAs who may unnecessarily steer clients away from valid and valuable planning opportunities. Your readers deserve accurate reporting and analysis by those qualified to provide it so they can exercise their own educated professional judgment.

David Neufeld, Esq., LL.M. (Tax)
Iselin, N.J.



Author's reply: My article was not intended for specialists who have LL.M. degrees, but for rank-and-file practitioners who may run across welfare benefit plans. Mr. Neufeld is partially correct in several of the points he makes, that is, the retiree medical plans are not proscribed, that cash-value insurance is not prohibited, that deductions for all welfare benefit plans are not denied, etc. However, the vast majority of welfare benefit plans I have seen are not of the variety that Mr. Neufeld describes, but are plans concocted for the purpose of selling cash-value life insurance products and

should be avoided. My goal was not to provide a comprehensive look at welfare benefit plans so that general practitioners can become expert enough to recommend legal arrangements, but to warn those practitioners so that they can spot a potential problem for themselves and for their clients. If they come across such a plan and need assistance determining whether it complies with tax laws, they should engage an expert who specializes in such plans. I have seen only one plan that my associates and I believe may be in full compliance with the tax laws. I will happily share information about it with anyone at lawallach@aol.com or 516-938-5007.

Lance Wallach, CLU, ChFC, CIMC
Plainview, N.Y.

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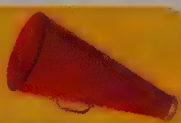
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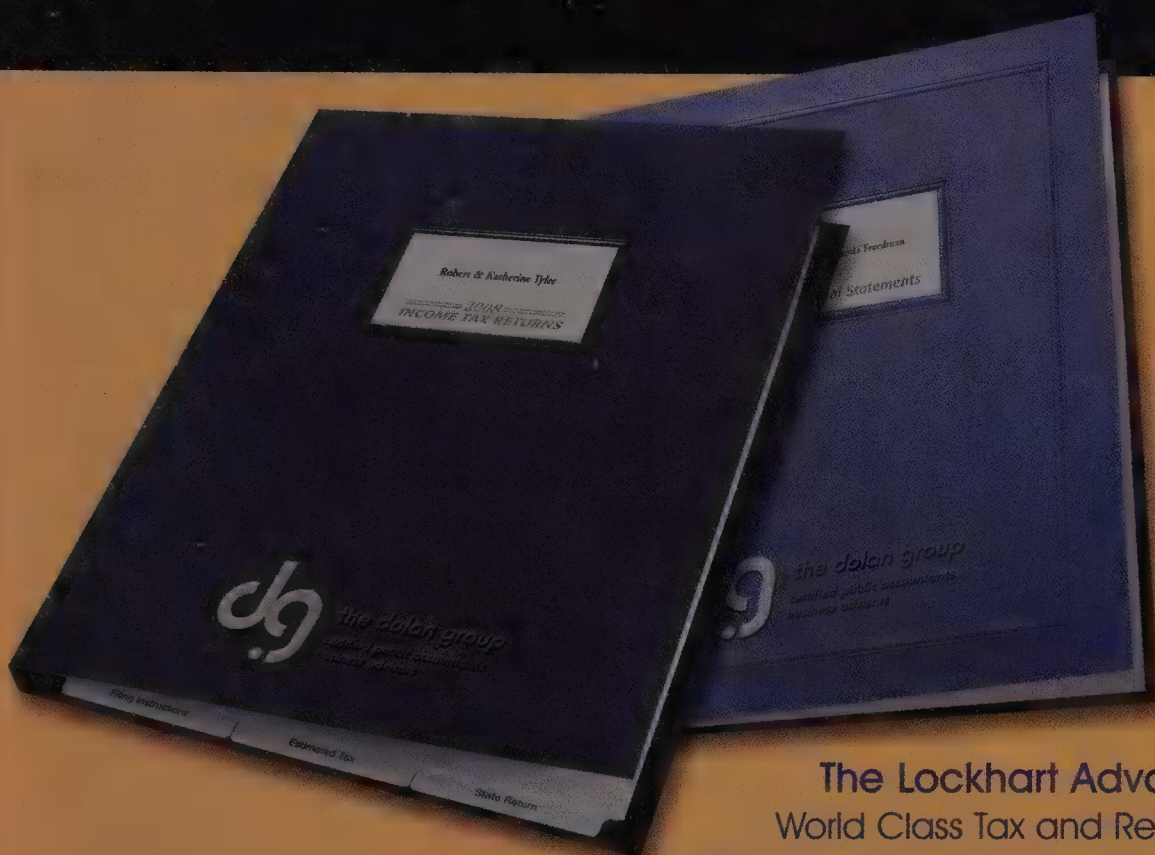
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News, People, Trends and Other Noteworthy Items

CAREERS AND RECRUITING

A Tale of Two Job Markets

Hiring managers in fields including accounting firms and technology are having a tough time finding qualified job candidates due in part to employees who fear switching jobs in an uncertain economy, according to a report issued by Robert Half International and CareerBuilder.com.

Among the findings in *The 2008 Employment Dynamics and Growth Expectations Report*:

- The primary recruiting challenge remains a shortage of qualified professionals, according to 59% of hiring managers.
- Nearly one in five hiring managers said the impact of higher gas prices and commuting costs is greatly affecting their ability to attract skilled employees.
- Recruiting a new full-time employee takes anywhere from four to 14 weeks, on average, depending on the position.
- Hiring managers estimate that 43% of the resumes they receive come from unqualified candidates.

Source: Robert Half International, www.rhi.com.

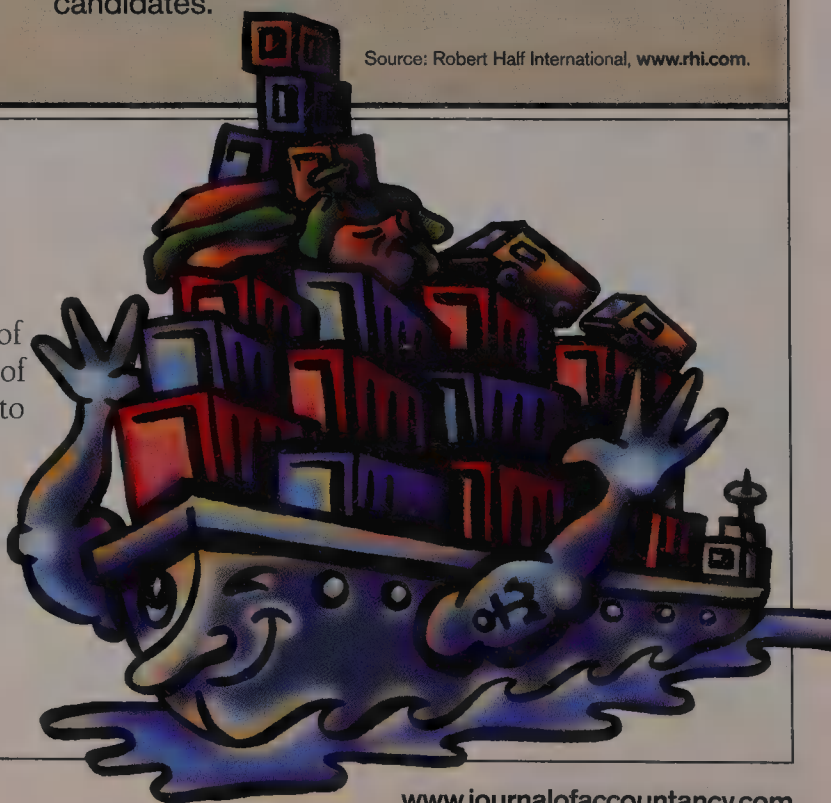
BUSINESS TRENDS

Behind the Export Boom

Industrial supplies and materials were the leading driver of export growth for the year ending in the second quarter of 2008, accounting for about 36% of the growth, according to the U.S. Bureau of Economic Analysis.

American exports grew at an inflation-adjusted rate of 11.8% in the 12 months studied. Capital goods, except automotive, accounted for about 34% of the growth; automotive, consumer and other goods accounted for about 22%; and foods, feeds and beverages accounted for about 8%.

Source: Bureau of Economic Analysis, www.bea.gov.





PUBLIC INFRASTRUCTURE

Could User Fees Break Gridlock?

Road user pricing is an effective approach to the gridlocked traffic facing many communities in the United States, according to a new study from Deloitte, *Changing Lanes: Addressing America's Congestion Problems Through Road User Pricing*.

The study cites statistics showing that in the United States in 2007 congestion caused 4.2 billion hours of travel delay and 2.9 billion gallons of wasted fuel, for a total cost of \$78.2 billion. At the same time, approximately 18% of the nation's more than 912,000 miles of roads and highways are in poor or mediocre condition, and approximately 27% of the nearly 594,000 U.S. bridges are structurally deficient or functionally obsolete.

The answer could be road user pricing, which links travelers' driving choices to the actual costs imposed on the traffic system. The study says pricing systems can be designed that both reduce traffic congestion and raise money to make needed repairs—but the system has to fit the need.

Road user pricing can be implemented in several ways, including pricing on a single corridor, pricing areas within dense urban environments during peak travel, and developing variable pricing for parking.

New York, Los Angeles, San Francisco, Chicago and Denver have each explored the potential for road user pricing in recent months.

Source: Deloitte, www.deloitte.com/us/transportation.

IN THE SPOTLIGHT

A Slowing Economy Affects Charitable Donations

It's the giving time of year, but will the checks to charities be a little smaller this year?

A 2008 examination of the *Giving USA* report on charitable donations by the Giving USA Foundation, a research and education organization for philanthropy, found that giving slows slightly during recessions.

In the five recessions since the one from 1973 to 1975, giving fell an average of 1.3%, adjusted for inflation.

In nonrecession years, from 1966 through 2006, giving rose an average of 4.3%.



Source: Giving USA Foundation, www.givingusa.org.



DATA POINT

69

Percentage of companies that said rising energy costs have led them to pass higher costs on to their customers.

Source: Grant Thornton Business Optimism Index, www.grantthornton.com.

BUSINESS TRENDS

Small Businesses Fret the Finances

What keeps small business owners up at night? The things they can't control, according to a study by the National Federation of Independent Business, sponsored by Wells Fargo.

The *Small Business Problems and Priorities* survey, based on responses from 3,530 small business owners, asked respondents to rate each of 75 possible business problems on a scale of 1 to 7 with 1 being "critical" and 7 being "not a problem."

Half of the top 10 problems worrying small business owners were costs, such as health care and energy. The remaining top 10 problems fall under tax, such as federal taxes on business income, property tax (real, inventory or personal property), tax complexity, and state taxes on business income.

The cost of health insurance continued its 20-year run as the No. 1 problem, with more than 55% of respondents saying it was "critical."

Source: National Federation of Independent Business, www.nfib.com.



DATA POINT

21

The average life span in months for a \$1 bill.

The U.S. Mint, as directed by the Presidential \$1 Coin Act of 2005, is promoting the use of dollar coins as a green alternative to the greenback. The mint says dollar coins last decades and that their use could save the government billions of dollars over many years. The Mint has minted more than 1 billion of the new presidential dollar coins since January 2007. Four designs are minted each year, honoring the presidents in the order in which they served.

Source: Bureau of Engraving and Printing, www.moneyfactory.gov; U.S. Mint, www.usmint.gov.

CAREERS AND RECRUITING

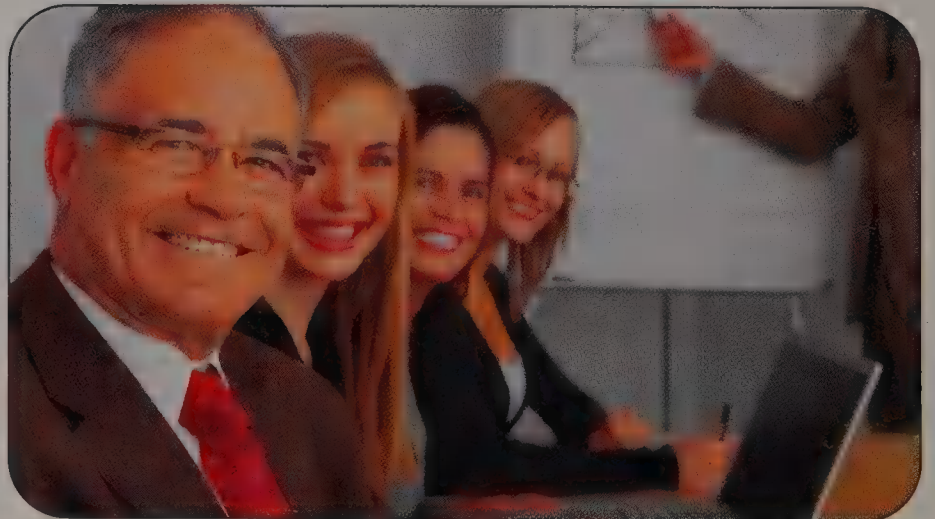
Retirement's Not Their Game

Between 1977 and 2007, employment of workers 65 and over increased 101%, compared to a much smaller increase of 59% for total employment (16 and over). The number of employed men 65 and over rose 75%, while employment of women 65 and older increased by nearly twice as much, climbing 147%.

And these older workers are working more. Most are full-timers: 56% in 2007, up from 44% in 1995.

While the number of employed people age 75 and over is relatively small (0.8% of the work force in 2007), this group had the most dramatic gain, increasing 172% between 1977 and 2007.

The increase in older workers can't be attributed to baby boomers, because in 2007 the baby-boom generation—those individuals born between 1946 and 1964—had not yet reached age 65.



Source: Current Population Survey, U.S. Bureau of Labor Statistics, www.bls.gov.

BUSINESS TRENDS

Hot Market for Forensic Services

The demand for CPAs providing forensic accounting services has accelerated, according to an AICPA survey.

More than two out of three CPAs polled (68%) say their forensic practices have grown over the past year.

The results were released in connection with the 2008 AICPA National Accounting Conference on Fraud and Litigation Services in October. The conference marked the official launch of a new credential exclusively for CPAs—Certified in Financial Forensics (CFF). The credential encompasses specialized skills that CPA practitioners apply in a variety of service areas, including bankruptcy and insolvency; comput-

er forensics; fraud investigations; family law; and litigation support, among others.

Of those respondents who reported increased demand for their services, 67% cited computation of economic damages as the leading reason, followed by marital disputes (56%) and investigations of financial statement fraud (54%).

AICPA research shows that CPAs represented 94% of forensic experts hired over the past two years.

More than 5,400 members of the AICPA's Forensic Valuation Services Section completed the survey.

Source: AICPA, www.aicpa.org.



PUBLIC ACCOUNTING

Top 100 Firms Post Double-Digit Growth for Three Years Running

The big keep getting bigger, according to CCH's most recent survey of the top 100 highest-revenue accounting firms.

According to the *Public Accounting Report* for 2008, the top 100 firms showed an average growth rate of 11.4%, up from 10.7% in 2007. This year's list actually includes 102 firms, as three tied for the last spot in the rankings.

The report shows no change in the top 10 firms from the previous year.

They are:

- 1. Deloitte
- 2. PricewaterhouseCoopers
- 3. Ernst & Young
- 4. KPMG
- 5. RSM McGladrey
- 6. Grant Thornton
- 7. BDO Seidman
- 8. CBIZ/Mayer Hoffman McCann
- 9. Crowe Group
- 10. BKD

Source: CCH *Public Accounting Report* 2008, www.cch.com.

BUSINESS TRENDS

U.S. Leads Way in "Cleantech" Investments

As climate change moves up the corporate agenda, "cleantech" investment is reaching record levels, according to Ernst & Young.

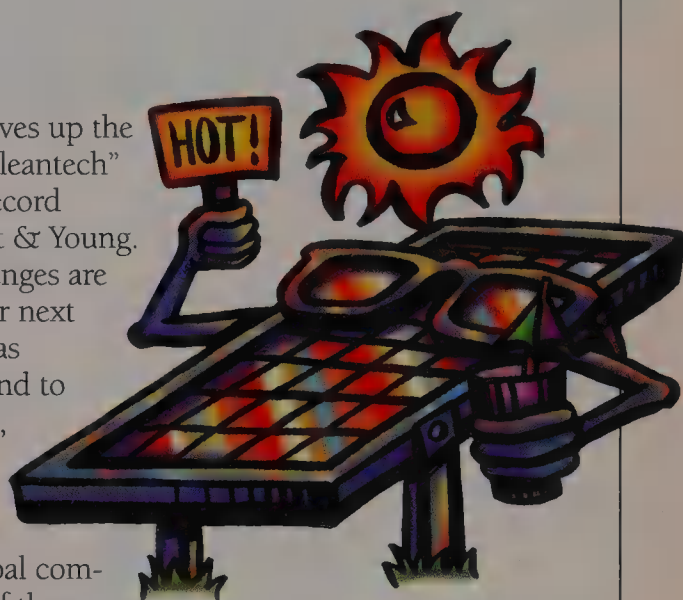
Climate change challenges are creating opportunities for next generation technologies as companies seek to respond to stakeholder expectations, current and anticipated regulation, and rising energy costs.

The study of 150 global companies found that 90% of those surveyed were undertaking climate change initiatives, with disclosed financial commitments totaling \$276 billion over the next 10 years.

This accelerated corporate response to climate change is reflected in global venture capital investment trends. As a proportion of global venture capital investment, cleantech has grown rapidly—up from just 1.6% of total investment in 2003 to 11% in 2008. And in terms of value, global venture capital investment in cleantech is set to significantly exceed the record \$3 billion invested last year, having already reached \$2.2 billion in the first six months of 2008.

The United States led the study with 301 venture-backed cleantech companies that have received cumulative investment of \$7.29 billion, weighted toward solar and biofuel companies. Similarly, Europe (203 companies), China (25) and Israel (16) are weighted toward solar manufacturing in terms of capital invested.

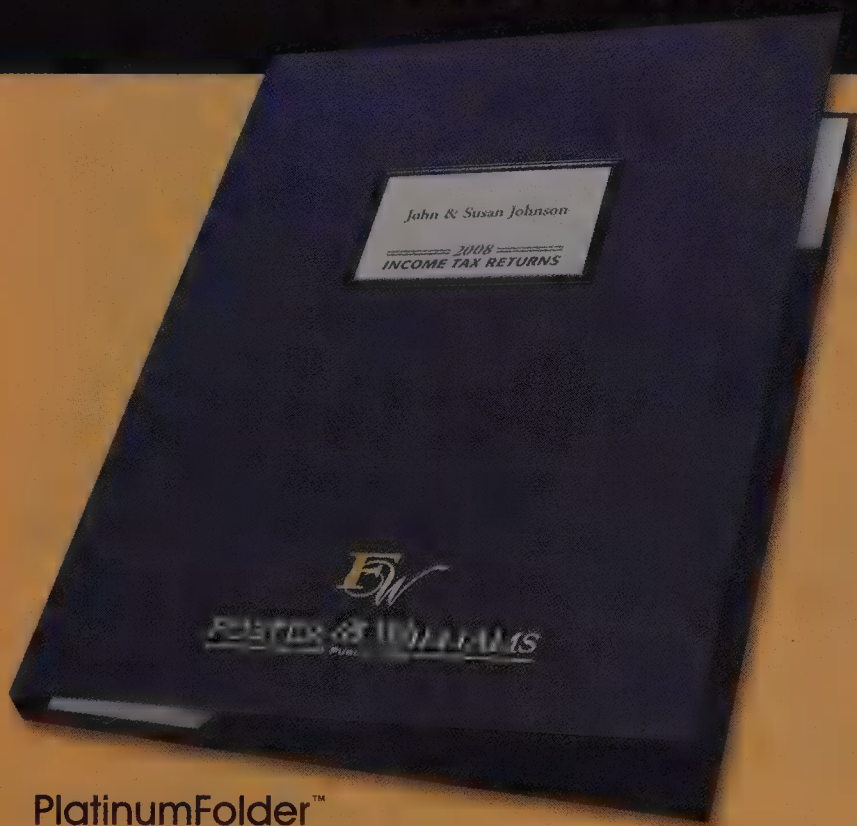
Source: Ernst & Young, www.ey.com.



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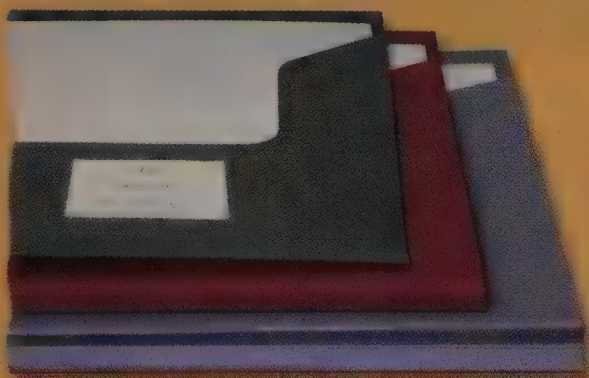


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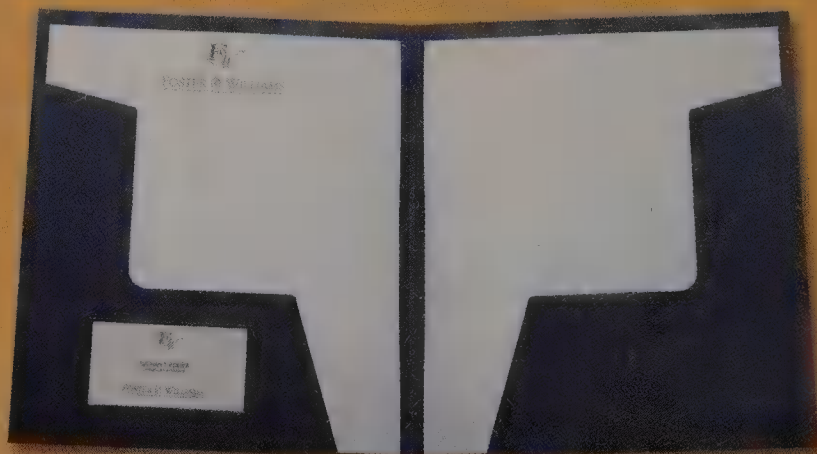
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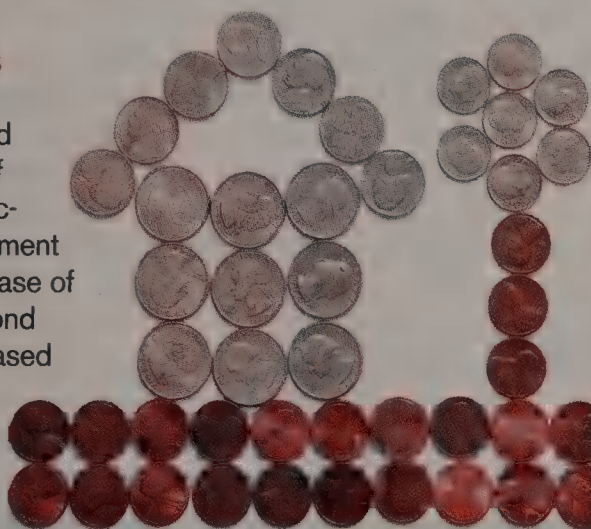
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Journal of Accountancy News Digest

Banks Pursue Non-Foreclosure Remedies

Data from nine national banks and five thrifts showed that the rate of increase of new loss mitigation actions—loan modifications and payment plans—exceeded the rate of increase of new foreclosures during the second quarter. While foreclosures increased 3.5% between the first and second quarters of 2008, loss mitigation actions increased by more than 21%.



	First Quarter 2008	Second Quarter 2008
Loan modifications	71,883	112,353
Payment plans	136,367	140,155
Total loss mitigation actions	208,250	252,508
New foreclosure actions	278,857	288,740
New loss mitigation actions relative to new foreclosures	75.68%	87.45%

Source: The OCC and OTS Mortgage Metrics Report, the Office of the Comptroller of the Currency, www.occ.treas.gov, and the Office of Thrift Supervision, www.ots.treas.gov.

BANKING

■ Actions by national banks and thrifts to prevent home mortgage foreclosures increased faster than new foreclosures in the second quarter of 2008, according to the *OCC and OTS Mortgage Metrics Report*. The report, issued jointly by the Office of the Comptroller of the Currency and the Office of Thrift Su-

pervision, replaces the separate reports previously issued by the federal banking regulators.

The report contains data on 34.7 million first-lien mortgages, worth more than \$6.1 trillion, held or serviced by national banks and thrifts. The data is collected from nine national banks and five savings associations, which hold approximately 60% of all first-lien mortgages in the United States.

The report shows that new loan modifications increased by more than 80% from January to June of 2008. Loss miti-

gation actions relative to new foreclosures averaged more than 87% during the second quarter, an increase of 12 percentage points from the first quarter. More than nine out of 10 mortgages remained current although credit declined in all risk categories. Early stage delinquencies (30 to 59 days past due) and seriously delinquent mortgages (60 or more days past due, or 30 or more days past due in the case of bankrupt borrowers) also increased.

The complete report is available at www.occ.treas.gov and www.ots.treas.gov.

FINANCIAL SERVICES

■ The Office of Thrift Supervision released a brochure to promote the benefits for businesses in the financial services industry of joining a regional coalition to prepare for recovery after a disaster.

The brochure, *Regional Coalitions: Public-Private Partnerships for the Financial Services Sector*, was developed and issued by the Financial and Banking Information Infrastructure Committee and the Financial Services Sector Coordinating Council for Critical Infrastructure Protection and Homeland Security. The regional coalitions were formed to help the financial services sector recover after a natural disaster or man-made attack. Membership is open to any business in the financial services sector and provides the ability to network with strategic partners in other critical sectors.

The brochure contains information about existing regional coalitions and how to join one or obtain information that could be useful in establishing a new coalition. The brochure is available at <http://files.ots.treas.gov/481131.pdf>.

■ Visit www.journalofaccountancy.com for news updated daily, and to sign up for e-mail news alerts on topics of your choice.

INTERNATIONAL

■ The International Public Sector Accounting Standards Board (IPSASB), an independent standard-setting board of the International Federation of Accountants (IFAC), has issued for comment the first in a series of consultation papers focused on developing an international public-sector conceptual framework. The consultation paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, identifies the IPSASB's preliminary views on the objectives and scope of financial reporting, the qualitative characteristics of information included in general purpose financial reports, and the characteristics of public-sector reporting entities.

Comments are due by March 31. The document is available at www.ifac.org/Guidance/EXD-Details.php?EDID=0119.

■ The International Auditing and Assurance Standards Board (IAASB), a standard-setting board under the auspices of

IFAC, released seven International Standards on Auditing. The ISAs are in a new style following the conventions to improve clarity. The clarified ISAs include ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, which contains an overview of an audit to aid in understanding its purpose and scope. The ISA also defines the respective authority of the requirements and guidance in ISAs and contains the most fundamental requirements for auditors. It emphasizes the importance of sound and consistent professional judgment by the auditor, and the necessity for sufficient audit evidence to support the auditor's opinion.

The IAASB also released:

- ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit*
- ISA 450 (Revised and Redrafted), *Evaluation of Misstatements Identified during the Audit*

- ISA 530 (Redrafted), *Audit Sampling*
- ISA 610 (Redrafted), *Using the Work of Internal Auditors*
- ISA 705 (Revised and Redrafted), *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised and Redrafted), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

The revisions in particular upgrade the standards in important areas of materiality, misstatements and reporting by the auditor, IAASB Chairman John Kellas said in a press release. The ISAs are part of the IAASB's program to redraft existing standards following clarity drafting conventions. As of Oct. 2, the IAASB had released 22 final clarity redrafted ISAs. The IAASB is on track to finalize its complete set of clarified ISAs by the end of this year. All clarified ISAs will be effective for audits of financial statements for periods beginning on or after Dec. 15, 2009.

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■ The AICPA filed a comment letter on the review of the International Accounting Standards Committee Foundation's (IASCF) Constitution. While expressing strong support for the objectives of the IASCF and the International Accounting Standards Board (IASB), the Institute:

■ Urged the IASCF to continue its efforts to secure permanent funding for the IASB's activities. The Institute said the SEC should use part of the current levy on U.S. public companies for accounting standard-setting activities as a permanent funding source for the IASB.

■ Supported the creation of a monitoring group, as envisioned by the IASCF, to formalize the link to public authorities. The Institute expressed support for the SEC having a seat on the monitoring group and recommends that the IASCF add a bank regulator to the group. If in the future many countries adopt the IASB's standard for private entities, the AICPA believes the IASCF should increase private entity constituency representation on the monitoring group.

■ Agreed with the IASCF's recommendation that a memorandum of understanding between the monitoring group and IASCF should be exposed for public comment.

■ Supported the establishment of operating protocols in a manner that fully maintains the IASB's independence, while providing sufficient oversight so that individual countries don't have a basis for "carve-out" exceptions to what the IASB promulgates.

■ Supported the proposed IASB geographic composition and the increased board size as reasonable changes.

■ Supported having a maximum of three part-time members of the IASB.

■ Called for the Trustees Appointments Advisory Group (TAAG) to continue to have an important role

to fill even with the creation of the monitoring group. Primarily, the TAAG will help ensure that the IASCF has a formalized mechanism to reach out to additional constituencies to gather "fresh" perspectives when identifying candidates to serve as IASCF Trustees.

The comment letter is available at www.ifrs.com/pdf/IASB_Comment_Letter.pdf.

SMALL BUSINESS

■ President Bush and Small Business Administration Acting Administrator Sandy Baruah met with women small business owners in Oklahoma City in September as part of a campaign to promote the benefits of health savings accounts (HSAs). The meeting highlighted the benefits of HSAs and included testimony from women business owners who have benefited from them or are considering them.

The roundtable discussion was part of the joint effort by the SBA, the National Economic Council and the Treasury Department to promote the benefits of

HSAs. Those agencies have also created a fact sheet that highlights the benefits of the accounts. More resources for small businesses and individuals are available at www.hsa.gov.

■ The SBA submitted a final rule on women-owned small business (WOSB) contracting procedures and a new proposed rule on the industries eligible for WOSB contracting assistance. The proposed rule would increase from four to 31 the number of industries under which a set aside could be established. The final rule sets procedures for implementing set asides in the eligible industries.

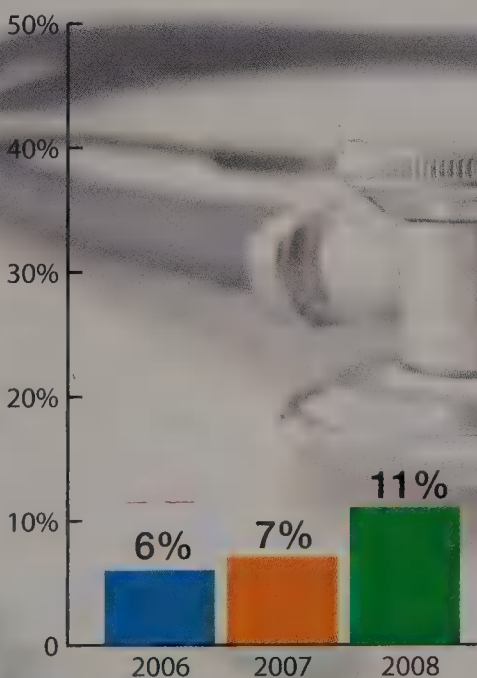
The final rule, which went into effect Oct. 31, is available at the *Federal Register* online at www.gpoaccess.gov/fr.

FYI

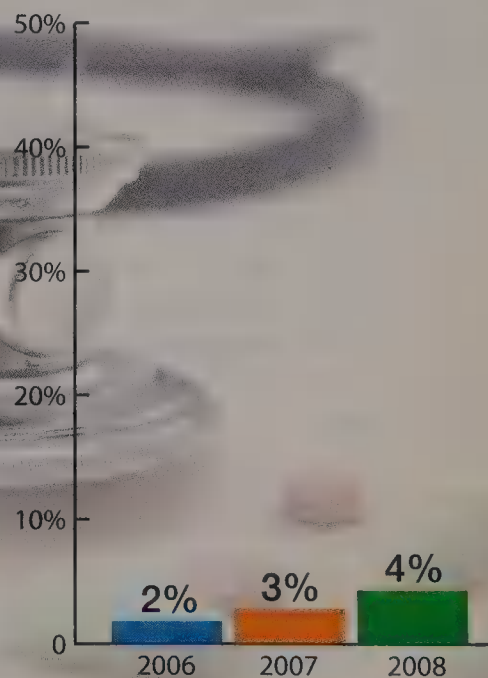
■ The Financial Accounting Foundation appointed Marc A. Siegel to the FASB board. His term was effective Oct. 20 and extends until June 30, 2013. Prior to his appointment, Siegel led the accounting research and analysis team at RiskMetrics Group in Rockville, Md. He succeeds George J. Batavick. ♦

HSAs Slow to Catch On

Percentage of Employers* Offering HSA-Qualified Health Plans



Percentage of Employees Enrolled in HSA-Qualified Health Plans



*Among employers offering health benefits

Source: *Employer Health Benefits 2008 Annual Survey*, The Henry J. Kaiser Family Foundation, www.kff.org.



WASHINGTON REPORT

2008 In Review: Congressional Impact on CPA Profession

by Lisa M. Dinackus

AICPA Congressional & Political Affairs Team

The AICPA enjoyed three legislative victories in Congress this year: equalizing IRS reporting standards for taxpayers and preparers, preventing the Farm Credit System from expanding its pool of borrowers, and maintaining financial and compliance audits for the government-backed Federal Housing Administration (FHA) loan program.

“SUBSTANTIAL AUTHORITY” SIGNED INTO LAW OCT. 3

The IRC § 6694 tax preparer standard was raised to the “more likely than not” standard in May 2007 as a part of the Iraq War funding bill. Reps. Joseph Crowley, D-N.Y., and Jim Ramstad, R-Minn., introduced legislation (HR 4318) on Dec. 6, 2007, to equalize the taxpayer and tax preparer standards at “substantial authority.” The bill had 49 co-sponsors. Sens. Kent Conrad, D-N.D., Jim Bunning, R-Ky., and Orrin Hatch, R-Utah, introduced a companion bill in the Senate (S 2851) on April 14, 2008. The bill had nine co-sponsors. Twenty state societies sent 28 members, who are on the House Ways & Means Committee or the Senate Finance Committee, letters of support. The AICPA engaged the following associations to support our position: ABA Tax Section, National Association of Black Accountants, National Association of Enrolled Agents, National Association of Tax Professionals, and Tax Executives Institute.

The legislation was part of the financial markets rescue package Congress passed and President Bush signed on Oct. 3. Equalizing the IRS reporting standards for taxpayers and tax preparers was the right thing to do. Congress understood that and acted quickly. The AICPA is thankful to Congress for its swift action.

FARM BILL ENACTED OVER VETO

The Farm Credit System (FCS) asked Congress to increase its pool of eligible borrowers to include entities that are involved in renewable energy. The provision was broad enough to include many nonagricultural businesses, for example, hardware stores in farm communities, truck and farm equipment dealers, and similar businesses that sell their goods

and services to farmers. The practical effect of this provision, if enacted, would have been to allow the FCS to offer these new eligible borrowers financial services, including audit, accounting and tax services. Because the FCS enjoys government tax and funding advantages that private-sector accounting firms would find difficult to compete with, the AICPA opposed the ability of the FCS to offer financial services to new eligible borrowers. We did not, however, oppose the expansion of the lending authority.

The Farm Bill (HR 6124) became law (PL 110-246) over the president's veto without the increased ability to lend to businesses involved with renewable energy.

FHA AUDITS

The AICPA's advocacy on Capitol Hill was successful in preventing Congress from lowering mortgage broker standards. A bill introduced early in the 110th Congress would have allowed a correspondent lender or mortgage broker who sells FHA loans to post a surety bond, in lieu of any requirement to provide audited financial statements or meet a minimum net worth requirement.

On July 30, President Bush signed the Housing and Economic Recovery Act of 2008 (PL 110-289). The purpose of the legislation is to assist homeowners facing foreclosure and improve oversight of mortgage giants Fannie Mae and Freddie Mac, which subsequently were taken over by the federal government in mid-September.

Congress did not change the FHA audit requirements, and the resulting law keeps in place the standards for audits that the FHA has long required: that mortgage lenders and brokers who sell FHA-insured loan products must first obtain a financial statement audit and meet minimum net worth requirements. In addition, the required compliance audit provides a check on whether lenders have complied with FHA laws and regulations.

The AICPA strongly opposed changing the audit requirement, and its message was successful: The audit is a tool that provides assurance that certain mortgage brokers have not materially misstated their financial condition. In addition, removing the audit requirement could permit bad actors to take advantage of FHA products to the detriment of borrowers and taxpayers.

ONGOING LEGISLATIVE CAMPAIGNS

Two of the accounting profession's legislative initiatives, tax strategy patents and multistate income tax, remain AICPA priorities. The push for passage of these bills will continue into the 111th Congress.

TAX STRATEGY PATENTS

The patentability of tax strategies is a growing concern among tax practitioners and taxpayers. In 1998, the Federal Circuit Court of Appeals, in *State Street Bank & Trust v. Signature Financial Group Inc.*, held that business methods could be patented. Since then, 70 patents for tax strategies have been granted, and at least 118 patent applications for tax planning methods are pending.

Patents for tax planning methods have already been granted

in a variety of areas, including the use of financial products, charitable giving, estate and gift tax, pension plans, tax-deferred exchanges, and deferred compensation. One patent granted is for the process of computing and disclosing the federal income tax consequences involved in converting a traditional IRA to a Roth IRA. We expect many more tax planning method patents to be issued, directly targeting average taxpayers in a host of areas including: (1) income tax minimization; (2) alternative minimum tax (AMT) minimization; and (3) income tax itemized deduction maximization.

The AICPA believes that patents granted for tax planning methods:

- Limit the ability of taxpayers to utilize fully interpretations of tax law intended by Congress;
- May cause some taxpayers to pay more tax than Congress intended and may cause other taxpayers to pay more tax than others similarly situated;
- Complicate the provision of tax advice by professionals;
- Hinder compliance by taxpayers;
- Mislead taxpayers into believing that a patented strategy is valid under the tax law; and
- Preclude tax professionals from challenging the validity of tax strategy patents.

The AICPA believes that patents for tax planning methods undermine the integrity, fairness and administration of the tax system and are contrary to sound public policy.

Legislation (HR 2365) was introduced by Reps. Rick Boucher, D-Va., and Bob Goodlatte, R-Va. The bill has 40 co-sponsors. The House passed a similar version of this bill as part of a larger patent reform bill (HR 1908) on Sept. 7, 2007.

In the Senate, Finance Committee Chairman Sen. Max Baucus, D-Mont., and Ranking Member Sen. Charles Grassley, R-Iowa, introduced tax strategy patent legislation (S 2369). The AICPA reached out to all 100 Senate offices, organized the delivery of more than 15 state society letters urging support and co-sponsorship, and engaged in a targeted lobbying campaign in six states with the help of state societies and key persons. The bill has 30 co-sponsors.

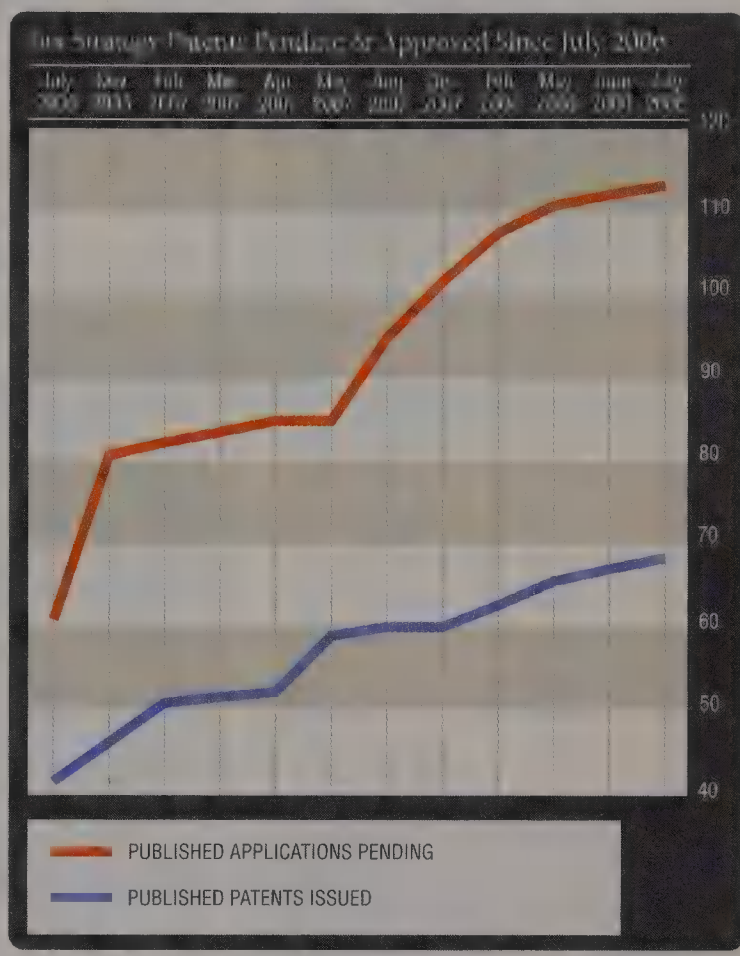
The prospects for 2009 are bright given that the bill passed the House last year and Finance Committee leaders have a strong ongoing commitment to it.

MULTISTATE INCOME TAX LEGISLATION

The Mobile Workforce State Income Tax Fairness and Simplification Act (HR 3359) creates a uniform national standard for state income tax withholding for employees who work in a state other than their state of residence for more than 60 days per year. The bill was introduced by Reps. Hank Johnson, D-Ga., and Chris Cannon, R-Utah. It applies only to employees: Partnerships must still determine where their income is from and file appropriate state partnership returns. Because state tax administrators and a coalition of business groups have recently reached a compromise, the outlook for

TAX PATENTS GRANTED: 70; TAX PATENTS PENDING: 118

With the number of tax strategy patents increasing, awareness by policymakers has increased, and there is more urgency to find a solution.



this issue next year is good. Rep. Johnson is planning to introduce the compromise language worked out this year in the next Congress and move it through the House Judiciary Committee, of which he is a member, and the full House.

SMALL BUSINESS HEALTH CARE

In June, the Small Business Health Options Program (SHOP) Act was introduced by a bipartisan group of House members. The bill seeks to improve access to affordable health care for small businesses through insurance market reform and tax incentives. A similar bill was also introduced in the Senate.

The legislation is targeted specifically for small businesses with 100 or fewer employees. SHOP seeks to lower costs and provide a simpler way to shop for and expand the choice of health insurance policies.

Key provisions of the SHOP Act include:

- Small business owners could join a state purchasing pool for health insurance.
- Participants would receive tax credits as an incentive.
- A nationwide purchasing pool would be offered beginning in 2011.

- A tax credit would be provided to small employers (including the self-employed) to help offset the cost of health coverage. SHOP's rating reforms would make premiums more stable from year to year and more affordable for those who need coverage the most.
- Health status rating would no longer be permitted in the SHOP pool and in state small group markets beginning in 2011, thus eliminating the large premium hikes that small businesses often face when even one employee experiences a serious illness.
- Variations in premium rates that insurers can charge would be reduced over time for plans sold through SHOP, so that small businesses would be better able to afford coverage without facing as much of a competitive disadvantage if they have older workers. A tax incentive would encourage states to adopt similar reforms in their state markets.
- SHOP would encourage statewide purchasing pools and would offer a nationwide pool beginning in 2011. These pools would reduce administrative costs by providing a more efficient way for insurers to market their health plans and for employers and employees to enroll in them. Today, 20% to 25% of a small business's premium goes to administrative costs instead of benefits, compared to 10% for large employers.

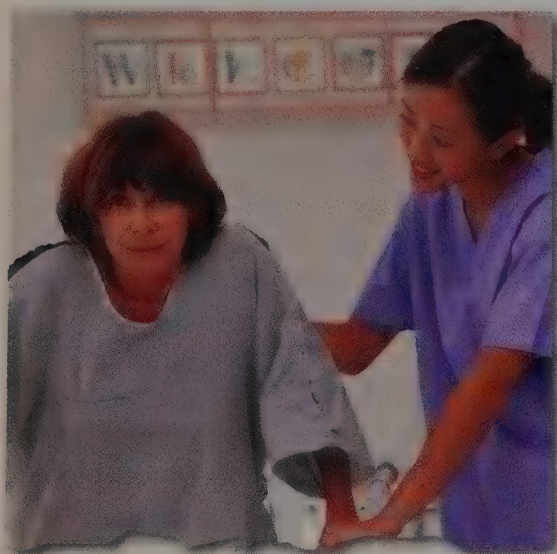
A series of hearings was held prior to the SHOP Act's introduction to hear from all stakeholders in the health care debate. The AICPA testified before the House Small Business Committee on the issues of affordable health care options for small businesses. Lee Groza, president of the Kentucky Society of CPAs, presented testimony on behalf of the AICPA.

OUTLOOK FOR THE 111TH CONGRESS

A larger Democratic majority in Congress, coupled with the Obama administration, means that liability reform is likely not on the agenda. Congress is likely to spend much of early 2009 looking at the credit crisis, which could lead to new regulation of the financial services sector, and accounting issues may be part of that discussion. The SEC will face heightened congressional scrutiny as part of this debate. The financial rescue bill calls for a 90-day SEC study of mark-to-market accounting due out in early January; this will coincide with the start of the 111th Congress and spark heated discussion. In addition, there may be an attempt to reverse the Supreme Court's *Stoneridge* decision. Many of Bush's tax cuts are expiring soon. There will be a major debate next year about which provisions, if any, should be extended. ♦

For further information on these legislative issues and congressional-related inquiries, please contact the Congressional and Political Affairs Team at congaaffairs@aicpa.org or 202-737-6600.

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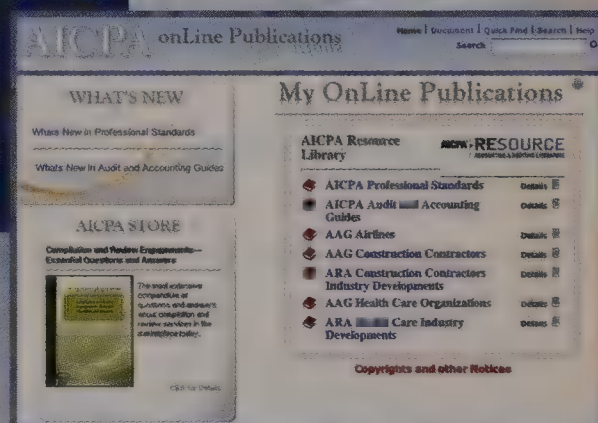
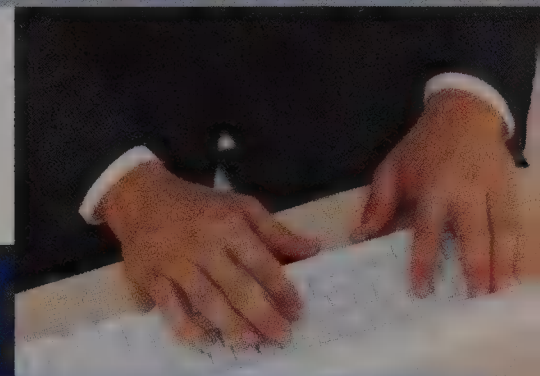
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FEEL RIGHT AT HOME

www.2minutecommuter.com

This blog offers commentary and advice for people who work out of their homes. Recent postings included advice on feeling secure in an insecure economy, a video review of telephone headsets, and an alert about "business opportunity" scams. The site also looks at how to avoid the isolation of working from home by co-working, or sharing space with a group of other self-

SMART STOPS

On the Web

employed professionals. Postings can be viewed by subject, such as "Business Ideas" or "Financing."

MAKE YOUR SMALL BUSINESS WORK

www.esmalloffice.com

This Smart Stop offers articles and weekly columns for the small business owner. It features a "Business Guide" with dozens of how-to articles offering advice on everything from writing a press release to analyzing profitability. Other articles are grouped into topics including "Starting Your Business," "Managing Your Money" and "Government Resources." The site licenses content from providers such as Commerce Clearing House, the Edward Lowe Foundation and the Kauffman Foundation. You can also sign up to receive a free monthly e-newsletter.

GENERAL INTEREST

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www.controlyourcredit.gov

Way more fun than a lecture, the U.S. Treasury's interactive site features The Bad Credit Hotel game, which provides information on keeping up a good credit score. The premise is to solve a mystery in a creepy hotel, with the goal of racking up enough credit tips to get to room 850—the perfect credit score—and unlock bonus information. Along the way, you collect clues on debt management, credit history and credit cards by clicking through to different rooms and clicking on key objects in each room. After collecting enough clues, players get to enjoy the secret perks found in room 850.

IT TAKES ONE TO KNOW ONE

www.whitecollarfraud.blogspot.com

Who knows fraud better than a fraud-

ster? Sam E. Antar, former Crazy Eddie Inc. CFO and convicted felon, shares his views and advice on white collar crime, securities fraud, internal controls, Sarbanes-Oxley and more on his blog. The introduction states, "The well-educated, skilled, and experienced accountant is the first line of defense for the capitalist system." And, toward that end, Antar points out inconsistencies in companies, organizations and governments, offers how-tos on detecting fraud, and muses on wrongdoings. You can browse by the most popular posts, learn more about the Crazy Eddie fraud scheme, check out fraud facts, and find related blogs in his list of links.

YOU DESERVE A BREAK

www.accountingcrosswords.com

If you're looking to kill some time while waiting for a flight or an appointment and have some accounting-related fun at the same time, this Smart Stop is for you. This site offers more than 50 crossword puzzles covering topics such as "Cash Flow Statement," "Bank Reconciliation" and many others.

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<http://customerservicezone.com>

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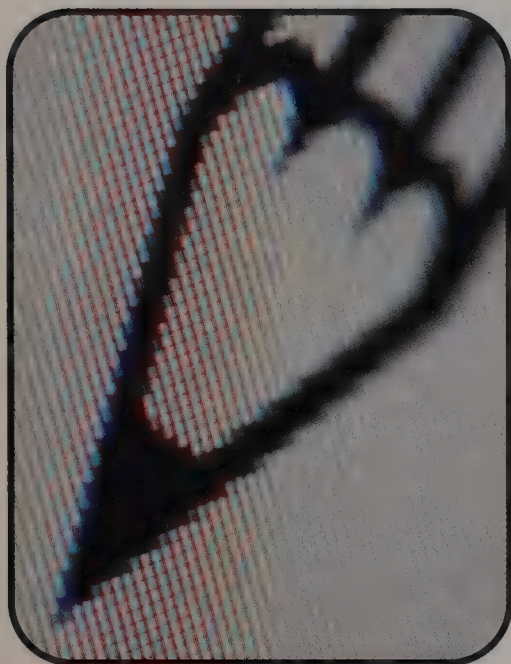
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CHECKLIST

Recruiting for Small Firms

The war for talent continues, and it's up to each small firm to create opportunities to find talented employees who will appreciate a small firm environment and prosper in it. It's often difficult for small firms to find the resources necessary to fuel a recruiting system that will fit their needs. The AICPA's Private Companies Practice Section (PCPS) provides the following tips on recruiting best practices for small firms:

✓ **Articulate your firm's unique differentiator.**

All firms have their pluses and minuses. The question is: What sets you apart from the rest? Ask your team members that question and use their responses to define your firm's unique selling features. Be sure to articulate this on your Web site and in marketing materials. According to the PCPS Small Firm Advantage Center's recruiting strategy brochure *Why a Smaller CPA Firm is a Great Place to Work*, differentiators might include easier access to firm owners, greater variety in assignments, respect for work/life balance, ability to create individual career timetables, and a family environment.

✓ **Conduct a firm needs assessment.**

Firms should take the time once a year to look at current employees, gauge the anticipated needs and internal promotion possibilities for the upcoming year, and then calculate future needs. This also is a good time to re-evaluate the firm's job qualifications and descriptions to make sure they align with the firm's vision.

✓ **Have a strong college and university presence.**

On-campus recruiting isn't reserved for the largest firms. Candidates need to know there are several

firm options, and it's up to them to figure out which firm makes the best fit based on size, culture and career growth opportunities. Small firms should be present at university professional nights, on-campus interview sessions, internship program activities and accounting club functions. Even in years when smaller firms may not anticipate a need, the firms should still have a presence on campus so that undergraduates see what is available to them two to three years down the road. Employees involved with on-campus recruiting need tools such as behavioral-based interview questions, sample letters and scripts.

✓ **Develop a formal internship program.**

With a strong campus presence comes the need for a strong internship program. Firms should consider having at least one intern per year for every anticipated open position in the firm. This gives the firm and the student the opportunity to "kick the tires." Firms should be careful, however, to make interns' work meaningful to give the intern and the firm the best opportunity to determine whether the fit is a good one.

✓ **Create a prospecting list database.**

Firms should get their younger team members involved in high school visits to increase interest in the profession. This in turn can be the start of a

prospecting list that the firm can use to track students and keep in touch with them during their college years. This not only increases the potential pool of candidates, but the on-campus involvement gives your younger team members a lesson in business development. The PCPS and many state societies provide presentation assistance and other resources for employees who are visiting campuses.

✓ **Look for nontraditional ways to find experienced recruits.**

If you haven't been tracking your candidates from on-campus recruiting, start capturing that data now. Firms can use a simple Excel spreadsheet to track recruits. The sheet should include how the person did in the initial interview, personal contact information including cell phone number, and where that recruit ended up working. Use that tracking list to go back three to five years and call people who previously were interested in your firm. Also, revisit your firm's alumni list of previous employees to see if any are looking to boomerang back to public accounting. In addition to tracking tools, Web tools such as LinkedIn, Plaxo, Facebook or MySpace can make it easier for firms of all sizes to keep in touch with recruits and alumni.

—The PCPS Human Capital Center is available at <http://pcps.aicpa.org/Resources/Human+Capital+Center/>.



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Component Materiality for Group Audits

by Steven M. Glover, Douglas F. Prawitt, Jonathan T. Liljegren and William F. Messier Jr.

Determining overall group materiality and materiality levels for individual components is becoming more of a hot-button issue as the number and complexity of large and international group audits increases. Auditing standards and other professional materials offer little practical guidance on the topic.

Internal and peer reviews and regulatory inspections have revealed a variety of approaches in this area. In some instances, reviews have discovered potentially troubling practices. Our conversations with regulators and practitioners indicate an intense and growing interest in the development of conceptually sound guidance. This article outlines a practical approach that group engagement partners can consider in establishing or evaluating component materiality.

GUIDANCE IN THE AUDITING STANDARDS

A group audit is performed on an entity with multiple locations or components, such as subsidiaries, with separately audited financial information included in consolidated or group financial statements. To properly plan the nature and extent of audit procedures for the group audit, the group engagement partner, who is the lead auditor for the consolidated entity, must determine group overall materiality and establish or approve appropriate materiality levels for the individual components. The component materiality level helps guide the component auditors in planning and performing audit procedures to achieve the desired level of audit risk at each component such that the group auditor achieves the desired level of group overall audit risk on the consolidated financial statements.

Exhibit 1

Continuum of Aggregate Component Materiality

Group overall materiality: \$5 million

Too Conservative

5 equal-sized components
Component materiality: \$1 million

$5 \times \$1 \text{ million} = \5 million

Too Aggressive

5 equal-sized components
Component materiality: \$5 million

$5 \times \$5 \text{ million} = \25 million

ISA 600 implies two extreme endpoints for the measure of aggregate component materiality.

U.S. auditing standards (AU section 312 and PCAOB's Auditing Standard no. 5, paragraphs B10–B16 of Appendix B) provide a list of factors to consider in determining the extent of testing on a multicomponent audit. However, these standards don't provide specific practical guidance on establishing component-

level planning materiality, one of the principal factors used to determine the extent of testing.

The International Auditing and Assurance Standards Board (IAASB) recently released a revised and redrafted International Standard on Auditing (ISA) 600, *Special Considerations—Audits of Group Fi-*

materiality:

1. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality level for the group financial statements as a whole, the component materiality level is set lower than the group materiality level.
2. Different materiality levels may be established for different components.
3. The component materiality level need not be an arithmetical portion of the group materiality level and, consequently, the aggregate of the component materiality levels may exceed the group materiality level.

Using the following examples, we hope to provide additional practical guidance to help group engagement partners navigate these guidelines.

nancial Statements (Including the Work of Component Auditors), to provide additional guidance to group engagement partners. Paragraphs 21–23 and A42–A46 of ISA 600 provide guidance to help inform group engagement partner materiality decisions. Paragraph A43 provides the following guidelines regarding component

EXECUTIVE SUMMARY

■ **Regulator inspections and firms' quality reviews have revealed** a variety of methods used by group engagement partners in determining component materiality and have identified potentially troubling matters with some of the current approaches.

■ **International Auditing Standard (IAS) no. 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)***, defines a con-

tinuum of materiality amounts that conceivably could be allocated to components. A reasonable, practical approach is allocating overall materiality to components while avoiding the extremes of the continuum.

■ **Benchmark multiples are suggested as reasonable upper bounds** for group engagement partners to consider when evaluating the appropriateness of aggregate component materiality and component materiality allocations. These

multiples are based on a simple probabilistic model that takes into account the number of components to which overall materiality is to be allocated and audit risk at the component and group levels.

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e-mail addresses, respectively, are glover@byu.edu and prawitt@byu.edu. **Jonathan T. Liljegren** is a recent graduate of Brigham Young University. He works for PricewaterhouseCoopers in the Washington, D.C., Metro office. His e-mail address is jonathan.liljegren@byu.net. **William F. Messier Jr., CPA, DBA,** is a professor of accounting at the University of Nevada–Las Vegas. His e-mail address is bill.messier@unlv.edu. He is a former ASB member.

AGGREGATE COMPONENT MATERIALITY

Aggregate component materiality is the sum of the individual component materiality amounts. ISA 600 implies two extreme endpoints for the measure of aggregate component materiality, one of which would generally be considered unnecessarily conservative and the other overly aggressive. Exhibit 1 illustrates the two extremes for an example company.

On the conservative extreme of the continuum, the group engagement partner could allocate an arithmetical portion of group overall materiality to each component, in which case aggregate component materiality is equal to group overall materiality. For example, given a group overall materiality of \$5 million, \$1 million is allocated to each of five equal-sized components.

On the aggressive end of the continuum, the group engagement partner could set materiality for each component at nearly the group overall materiality figure, resulting in an aggregate component materiality that far exceeds group over-

all materiality. For example, given a group overall materiality of \$5 million, approximately \$5 million is allocated to each of five equal-sized components.

Allocating full group materiality to each component results in an unacceptably high risk of audit failure. To illustrate this, assume that the desired audit risk at each component is 5%. Since each component is allocated the full amount of group overall materiality, the risk of an undetected material misstatement at the group level is the likelihood that any one of the five components has an undetected material misstatement, which is about 23% ($1 - (0.95)^5$). Note that aggregate component materiality can exceed group overall materiality for many of the same reasons that the aggregate of tolerable misstatement allocated to account balances can exceed overall materiality in a financial statement audit.

Conversely, allocating an arithmetic portion—a simple proportion—of group overall materiality would generally result in over-auditing because the

achieved audit risk at the group level would be extremely low.

While ISA 600 implies it is appropriate for group engagement partners to avoid the extreme endpoints of the continuum shown in Exhibit 1, it does not spell out how to determine a reasonable and justifiable level of aggregate component materiality between these two extremes.

MAXIMUM AGGREGATE COMPONENT MATERIALITY

Aggregate component materiality can be expressed as a multiple of group overall materiality. Using Exhibit 1, the conservative extreme indicates a multiple of 1 (\$5 million ÷ \$5 million = 1), whereas the aggressive extreme indicates a multiple of 5 (\$25 million ÷ \$5 million = 5). We developed a probabilistic model to generate multiples that can be applied to calculate a reasonable upper bound for aggregate component materiality based on the group overall materiality level and the number of components (for a complete description of the model, see the online version of this article at www.journalofaccountancy.com by entering code 2008953 in the search box).

The multiples derived from the model to determine the *maximum aggregate component materiality* (MACM) are presented in Exhibit 2. We refer to these MACM multiples as benchmark multiples.

Our set of benchmark multiples assumes that the group engagement partner has used appropriate professional judgment to determine the number of significant components to which MACM will be allocated, including removing any insignificant components that are immaterial in aggregate and that are of sufficiently low risk (in accordance with ISA 600, paragraphs A50–A53).

To determine the upper bound suggested by the model, the group engagement partner multiplies group overall materiality by the appropriate benchmark multiple from the table and then uses the calculated MACM as a reference point in establishing component materiality levels or evaluating the component materiality

Exhibit 2 Benchmark Multiples

Number of significant components to which MACM will be allocated	Multiple applied to group overall materiality to determine maximum aggregate component materiality (MACM)
2	1.5
3–4	2.0
5–6	2.5
7–9	3.0
10–14	3.5
15–19	4.0
20–25	4.5
26–30	5.0
31–40	5.5
41–50	6.0
51–64	6.5
65–80	7.0
81–94	7.5
95–110	8.0
111–130	8.5
131+	9.0

levels proposed by component auditors.

Returning to our example of a group audit with five components, applying the benchmark multiple of 2.5 to group overall materiality of \$5 million yields an MACM of \$12.5 million—a reasonable

upper bound available for allocation to the components. See the sidebar, “Approaches for Allocating MACM,” for additional examples using the benchmark multiples to calculate MACM.

It is important to note that in evalu-

ating audit results, the aggregate of known and projected misstatements from all components cannot exceed group overall materiality. Thus, even though the total amount of materiality allocated to the components (\$12.5 million in our example) can exceed group overall materiality (\$5 million in our example), evaluation of the aggregated known and projected audit differences for the consolidated entity is conducted using group overall materiality.

Approaches for Allocating MACM

These examples allocate MACM to components based on revenues; other financial bases could also be used.

Company 1

Number of Components		5		
Benchmark Multiple		2.5		
Group Overall Materiality		1,000,000		
Maximum aggregate component materiality based on benchmark multiples (MACM)		2,500,000		
		1	2	3
Component Revenues		Proportional Allocation of MACM	Weighted Allocation of MACM*	Component Materiality
1	60,000,000	750,000	622,847	700,000
2	50,000,000	625,000	568,579	600,000
3	40,000,000	500,000	508,553	500,000
4	30,000,000	375,000	440,420	400,000
5	20,000,000	250,000	359,601	300,000
Aggregate Component Materiality		2,500,000	2,500,000	2,500,000

* See “Illustrative weighted allocation formula for component materiality” on page 46.

In this example, the group engagement partner multiplies the benchmark multiple of 2.5 (the multiple pertaining to five components—see Exhibit 2) by the group overall materiality of \$1 million to determine the maximum aggregate component materiality, which is \$2.5 million.

For a simple proportional allocation of MACM (column 1), divide component revenues by total revenues, and multiply by MACM (for example to compute the allocation for component 5: $250,000 = 2,500,000 \times 20,000,000 \div 200,000,000$).

For a weighted allocation of MACM (column 2), first take the square root of each component's revenues and then take the sum of the square roots of all individual components' revenues to compute the denominator for the weighted allocation formula (see illustrative weighted allocation formula on page 46). The square root of each component's revenues is divided by the denominator and is then multiplied by MACM to determine the weighted allocation (for example, to compute component 5's allocation: $359,601 = 2,500,000 \times 4,472 \div (7,746 + 7,071 + 6,324 + 5,477 + 4,472)$).

After considering the potential allocation approaches, the engagement partner established the final component materiality levels shown in column 3.

(Continued on page 46)

ADDITIONAL GUIDELINES FOR ESTABLISHING COMPONENT MATERIALITY

Now that we have determined a reasonable level of aggregate component materiality, the question becomes how to allocate this amount to components. In practice, it's common for the component materiality levels to vary due to differing component sizes, statutory audit requirements, risk characteristics and country-specific guidelines. The group engagement partner allocates the MACM to the significant components using either proportional or weighted allocation techniques.

An example of a weighted allocation technique is to take the square root of a component's revenues and divide it by the sum of the square roots of each component's revenues. The result is multiplied by MACM to determine materiality for that component.

The proportional or weighted allocation techniques provide group engagement partners with a preliminary allocation strictly based on size. The preliminary allocation is then adjusted as appropriate based on each component's risk characteristics. The sidebar provides examples of how both of these allocation techniques can be used.

When there are different-sized components or required limits on the amount of materiality that can be allocated to some components, as in statutory audits, the following guidelines help ensure that the allocation achieves the desired level of audit risk at the group level:

1. Each component should receive an

(Continued from page 45)

Approaches for Allocating MACM

Company 2

Number of Components		5		
Benchmark Multiple		2.5		
Group Overall Materiality		2,650,000		
Maximum aggregate component materiality based on benchmark multiples (MACM)		6,625,000		
Component Revenues		1 Proportional Allocation of MACM	2 Weighted Allocation of MACM*	3 Component Materiality
1	250,000,000	3,125,000	2,292,471	2,100,000
2	150,000,000	1,875,000	1,775,740	1,600,000
3	100,000,000	1,250,000	1,149,886	1,100,000
4	20,000,000	250,000	648,409	500,000
5	10,000,000	125,000	458,494	300,000
Aggregate Component Materiality		6,625,000	6,625,000	5,600,000

* See below, "Illustrative weighted allocation formula for component materiality."

The significant size differences among the components of Company 2 preclude using strictly proportional or weighted allocations of the maximum aggregate component materiality (MACM). Under a simple proportional allocation approach (column 1), the largest component would have been allocated more than group overall materiality, which violates ISA 600. The allocation guidelines in the article also suggest that the aggregate allocation of materiality to the largest components not exceed the level indicated by the benchmark multiples. Thus, the three largest components should receive no more than two times group overall materiality (in this case, \$5.3 million).

However, a proportional allocation of MACM would result in \$6.25 million in aggregate being allocated to the three largest components, and the weighted allocation of MACM would result in \$5,518,097 in aggregate being allocated to the three largest components. Therefore, considering the risk characteristics of the components, the materiality allocations shown in the component materiality column (3) would be appropriate.

Illustrative weighted allocation formula for component materiality

$$\text{Component } i \text{ materiality} = \text{Maximum aggregate component materiality (MACM)} \times \frac{\sqrt{\text{Amount of component } i \text{ revenues}^\dagger}}{\sum_{j=1}^n \sqrt{\text{Amount of component } j \text{ revenues}^\dagger}}$$

† Other appropriate, stable financial bases or measures could similarly be used by auditors in the weighted allocation formula

allocation that is less than group overall materiality (see ISA 600, paragraph A43).

- The aggregate component materiality for the largest components is generally kept within the benchmark multiple for that number of components. For example, if a group is composed of three large components and 35 relatively small components, the group engagement partner would not likely allocate more than two times group overall materiality in aggregate to the three large components, based on the suggested benchmark multiple associated with three components.

While the approach we suggest will help inform the group engagement partner's judgment, we stress that because of the complexity and subjectivity of the variables involved, no single "correct" or "optimal" solution is possible. Auditors should apply appropriate professional judgment and follow local standards when establishing the materiality allocation for each component. ♦

AICPA RESOURCES

Publication

Omnibus Statement on Auditing Standards—2002—SAS No. 98 (#060700)

For more information or to place an order, go to www.cpa2biz.com or call the Institute at 888-777-7077.

Web site

AICPA's Auditing Standards Board, <http://tinyurl.com/3qyu5x>.

OTHER RESOURCES

Web site

PCAOB, www.pcaob.org

Publication

ISA 600, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors), www.ifac.org/store.

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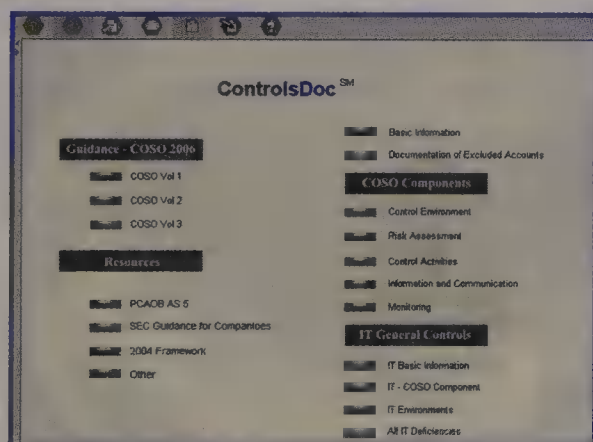
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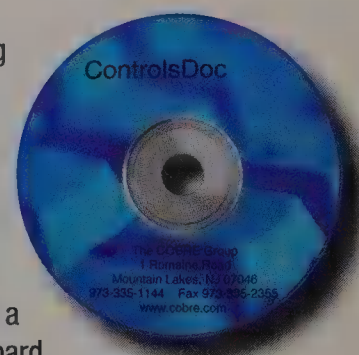
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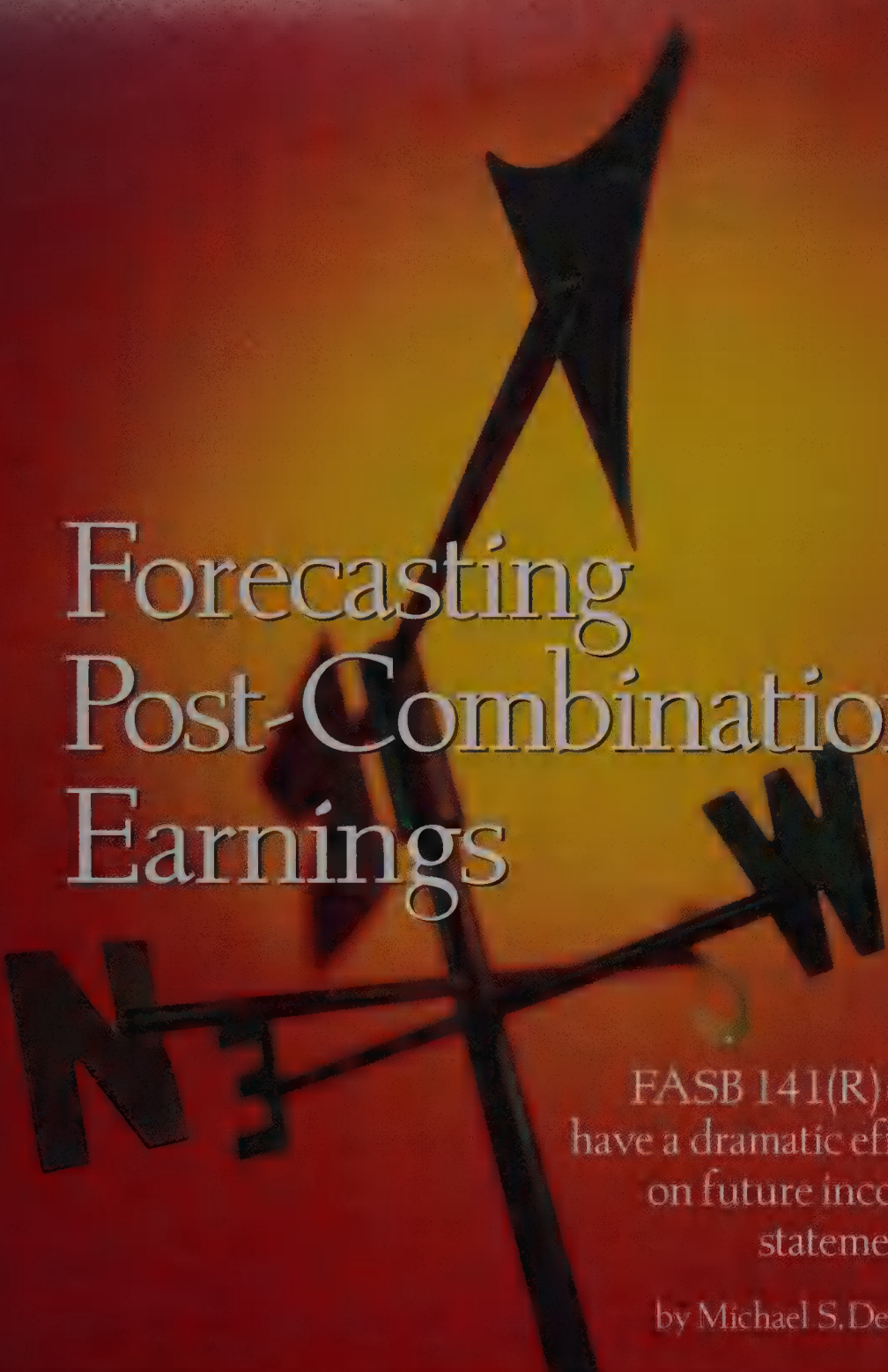
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Forecasting Post-Combination Earnings

FASB 141(R) can
have a dramatic effect
on future income
statements.

by Michael S. Devine

The acquisition method of financial accounting for business combinations under FASB Statement no. 141(R), *Business Combinations*, requires the acquiring company to recognize and measure all identifiable assets acquired, liabilities assumed and any noncontrolling interest in the acquired company as of the acquisition date at their respective fair values. The assets acquired may include assets that are not included on the acquiree's balance sheet because they were expensed or written off before the acquisition date. Additionally, the acquirer may record liabilities arising from contingencies at the acquisition date that were not recorded by the acquiree. This article suggests a method for management to forecast the effects of a business combination on reported earnings.

Due to numerous possible factors, the effect of recording the business combination under Statement no. 141(R) on post-combination earnings can be significant. The following examples illustrate the potential magnitude of this effect:

- Assuming adequate inventory turnover, the entire difference between the acquisition-date fair value and previously recorded book value of inventory (valued on a FIFO basis) of the acquired company could be charged to cost of sales in the first few months following the business combination.
- The excess of acquisition-date fair values over recorded net book values for plant and equipment would result in higher depreciation charges over the remaining useful lives of the assets after the business combination.
- Intangible assets not previously recorded in the financial statements by the acquired company would be recorded at their respective acquisition-date fair values and amortized over the respective remaining useful economic lives of the intangible assets. An example would be a license (with substantial renewal costs) that was not recognized as an asset by the acquiree before the acquisition because the development costs of the license were internal and charged to expense. Acquired in-process research and development would be recorded at fair value by the acquirer and would be subject to post-combination impairment but would not be amortized.
- If the terms of an acquiree's operating lease are favorable in relation to market terms for a similar lease at the acquisition date, the acquirer would record an intangible asset (in most cases) for the difference between contract terms and market terms.

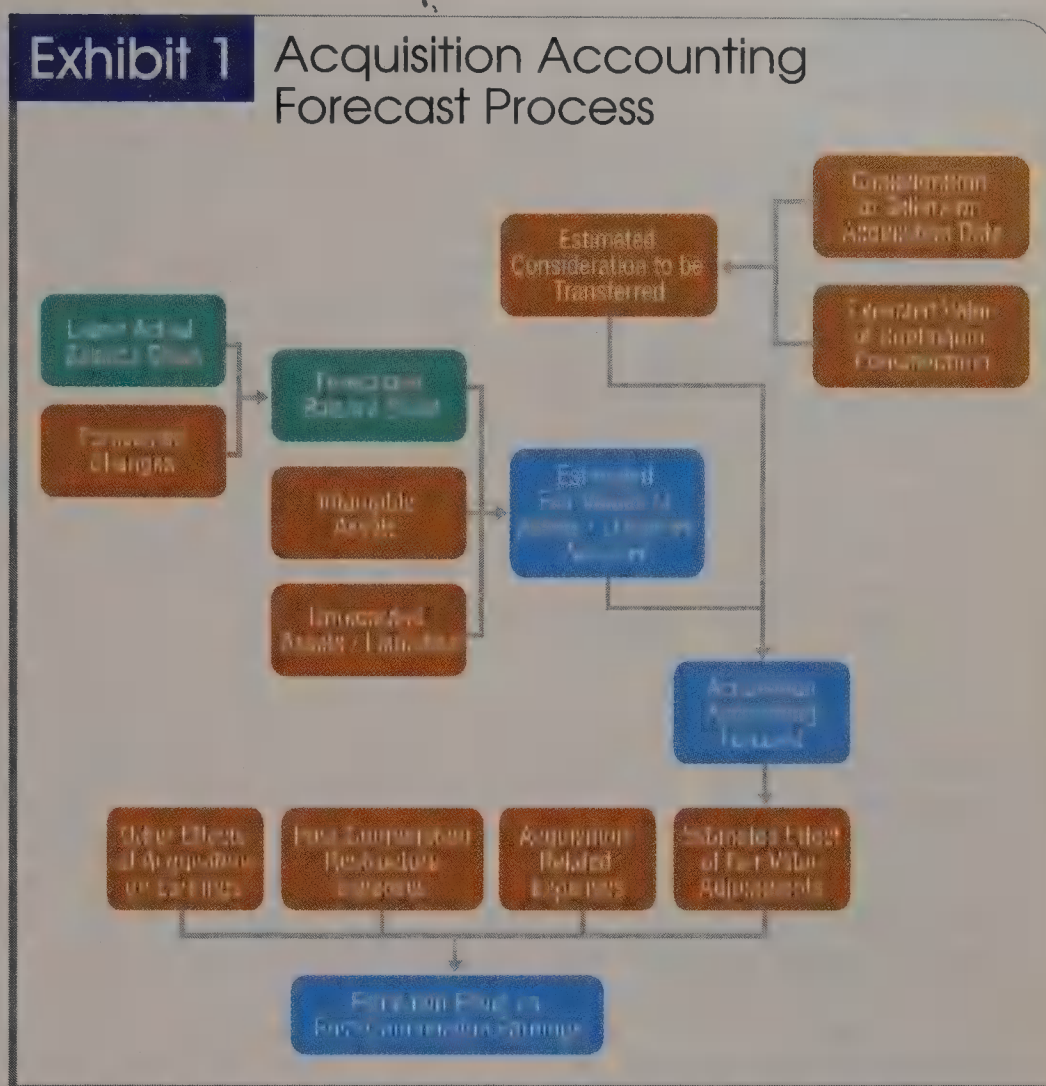
Because of the potential effect of the recorded business combination on post-acquisition earnings, the acquiring company should develop an acquisition accounting forecast to estimate the future income statement effects. Discussed below is a suggested approach for developing this acquisition accounting forecast (which is for internal management analysis purposes). Due to the enormous complexity and

variability of accounting, tax and other considerations, the comments and acquisition example in this article are intended to be illustrative rather than all-inclusive. The sample business combination assumes a single transaction (that is, not a "step" acquisition), the absence of a noncontrolling interest (that is, 100% equity interest acquired), no previously held equity interest in the acquiree, and does not include deferred income tax considerations. Specific applications of this approach should obviously be customized to the substance and details of the transaction.

DEVELOPING THE ACQUISITION ACCOUNTING FORECAST

The process for developing the acquisition accounting forecast is shown in Exhibit 1.

The first step is to estimate the total fair value of consideration to be transferred to the seller. It is assumed that the purchase price has already been determined, based on projected revenue, earnings and/or cash flows of the acquiree and numerous other factors. In addition to the expected consideration to be paid to the seller at closing (cash payments, fair value of equity interests issued by the acquirer and/or liabilities incurred by the acquirer to sellers), many business combinations also include contingent consideration (for example, earnouts based on achievement of post-acquisition earnings or other objectives). Statement no. 141(R) requires that the ac-



quiring company recognize the acquisition-date fair value of contingent consideration as part of the total consideration transferred.

In preparing the acquisition accounting forecast, the expected value of the contingent consideration should also be includ-

ed. One possible method for determining this value is to assign expected probabilities to the range of consideration values. In the example, management estimated a 60% probability that the acquiree's earnings would result in additional consideration of \$2 million and a 40% probability of \$1.5 million. ➤

EXECUTIVE SUMMARY

Under the acquisition method of financial accounting for business combinations as required by FASB Statement no. 141(R), the acquiring company should recognize and measure all identifiable assets acquired and liabilities assumed of an acquired company as of the acquisition date at their respective fair values.

Due to numerous possible factors, the effect of recording the business combination under Statement no. 141(R) on post-combination earnings can

be significant. Examples include higher depreciation charges on the excess of acquisition-date fair values of plant and equipment over carrying values and the amortization of intangible assets previously not recorded by the acquiree.

Because of the potential impact of the recorded business combination on post-acquisition earnings, the acquiring company should develop an acquisition accounting forecast to estimate the income state-

ment effects. The forecast would include estimating the fair value of consideration, including contingent consideration; developing a forecasted historical cost balance sheet of the acquiree and adjusting the balance sheet to fair values; estimating the time periods over which the fair value adjustments will be included in post-combination earnings; and estimating acquisition expenses and other incremental effects of the acquisition.

By integrating the impact of

the acquisition accounting forecast and other effects of the business combination with the forecasted operating results (using carrying values) for the acquired company, the acquirer can obtain a more complete picture of post-combination earnings.

Michael S. Devine, CPA, MBA, is a senior manager in accounting and business services for AC Lordi Consulting LLC, in West Chester, Pa. His e-mail address is mdevine@aclordi.com.

Exhibit 2

Forecasted Balance Sheet of Acquired Company (\$ in thousands)		Acquiree Carrying Value	Fair Value Adjustments	(Ref.)	Fair Value
Cash		\$ 300	\$ —		\$ 300
Trade accounts receivable		7,600	(300)	(1)	7,300
Other receivables		200			200
Inventory		6,200	800	(2)	7,000
Other current assets		200			200
Total current assets		14,500	500		15,000
Land		1,000	100	(3a)	1,100
Plant and equipment		17,000	5,800	(3b)	22,800
Intangible assets:					
Royalty agreement		—	200	(4a)	200
Favorable lease		—	120	(4b)	120
Customer contracts and relationships		—	500	(4c)	500
Goodwill of acquiree (written off by acquirer)		1,000	(1,000)	(5)	—
Total assets acquired		33,500	6,220		39,720
Current liabilities		10,000			10,000
Contractual contingency liability		—	400	(6)	400
Long-term debt		4,600			4,600
Total liabilities assumed		14,600	400		15,000
Net assets acquired		\$18,900	\$5,820		\$24,720
Consideration to seller on acquisition date					\$25,300
Estimated contingent consideration					1,800
Total consideration					27,100
Goodwill recorded by acquiring company					\$2,380

Increase in Net Assets Acquired								\$ 5,820
Less: fair value adjustment for land (not depreciated)						(3a)		\$(100)
Add back: write-off of acquiree goodwill (no income effect)						(5)		\$ 1,000
Acquisition-related costs (expensed)						(a)		300
Post-combination restructuring expense						(b)		500
Net Decrease in Pretax Earnings								\$ 7,520

Increase (Decrease) in Post-Combination Pretax Earnings								
	Year						Total	(Ref.)
	Year 1	Year 2	Year 3	Year 4	Year 5	6 - 10		
Uncollectible accounts receivable	\$ 300	\$ —	\$ —	\$ —	\$ —	\$ —	\$300	(1)
Additional cost of sales (FIFO valued inventories)	(800)	—	—	—	—	—	(800)	(2)
Additional depreciation	(580)	(580)	(580)	(580)	(580)	(2,900)	(5,800)	(3b)
Amortization of royalty agreement	(100)	(100)	—	—	—	—	(200)	(4a)
Amortization of favorable lease	(40)	(40)	(40)	—	—	—	(120)	(4b)
Amortization of customer contracts / relationships	(250)	(250)	—	—	—	—	(500)	(4c)
Contractual contingency	400	—	—	—	—	—	400	(6)
Acquisition-related expenses	(300)	—	—	—	—	—	(300)	(a)
Restructuring expense	(500)	—	—	—	—	—	(500)	(b)
Net Decrease in Pretax Earnings	\$(1,870)	\$(970)	\$(620)	\$(580)	\$(580)	\$(2,900)	\$(7,520)	

million, and the acquisition accounting forecast included contingent consideration of \$1.8 million $[(\$2.0 \text{ million} \times 60\%) + (\$1.5 \text{ million} \times 40\%)]$. Other techniques for estimating the acquiree's expected earnings could also be used.

In addition to consideration, incremental acquisition-related costs such as legal costs, finder fees, appraisal fees, environmental study costs, and accounting costs should be estimated and included in the acquisition accounting forecast. The acquiring company should be able to reasonably estimate such costs based on normal finder fee and appraisal fee ranges and discussions with lawyers, accountants, valuation professionals, engineers and other consultants. Statement no. 141(R) requires that direct costs of the acquisition be expensed by the acquirer when incurred and not be included in the cost of the business combination. Acquisition-related costs that are expensed should include any reimbursements to the acquiree or sellers for paying the acquirer's acquisition costs.

Once the consideration and acquisition-related costs have been estimated, the next step is to develop a pro forma balance sheet as of the anticipated acquisition date. This balance sheet would be on a historical cost basis and could be developed by adjusting the latest reported balance sheet with forecasted changes in financial position up to the expected acquisition date.

In some cases, this balance sheet will already have been developed in conjunction with the initial analysis of the acquisition. In other cases, the forecasted balances can be derived (using the latest reported balance sheet) via analysis of trended financial ratios such as DSO (days sales outstanding) and inventory turnover, expected capital expenditures up to the acquisition date, and other factors.

The forecasted balance sheet should then be converted from a historical cost basis to a fair value basis. This step is the most important as well as the most difficult task. The comments below reference the forecasted balance sheet in Exhibit 2. As noted above, the example in Exhibit 2 excludes deferred income tax considerations.

- 1) **Trade accounts receivable.** The forecasted historical cost of trade receivables in the acquisition example was derived by applying the acquiree's historical DSO ratio to forecasted sales before the acquisition date. The fair value of receivables should be determined as the present value of amounts to be received using an appropriate interest rate, less estimated uncollectible accounts and collection costs. In this example, the acquiree's low DSO precluded the necessity for present values, but it was estimated that an additional \$300,000 of receivables at the acquisition date would be uncollectible (based on a bankruptcy filing by one of the acquiree's customers).
- 2) **Inventory.** Fair value guidelines are summarized as follows: raw materials should be valued at current replacement costs; finished goods should be valued at estimated selling prices less selling costs and reasonable profit allowance for selling effort; and work in process inventory should be valued similarly to finished goods except that the cost to complete should also be deducted. The first step in estimating the fair value of inventory is to estimate the amount of inventory by category on a historical cost basis. This can be accomplished by reviewing the trend of inventory by category—that is, if the relative proportions of inventory categories to total inventory have remained stable, the historical percentages can be applied to total inventory on the forecasted balance sheet. Other estimating techniques would be needed, of course, if historical experience was more variable. After the inventory amounts by category have been estimated, the selling prices, costs to complete, and so on should be estimated and applied as outlined above to the appropriate inventory categories. In the acquisition example, the entire process resulted in a net increase for inventory (valued at FIFO) at the acquisition date of \$800,000.
- 3) **Property, plant and equipment.** For purposes of developing the acquisition

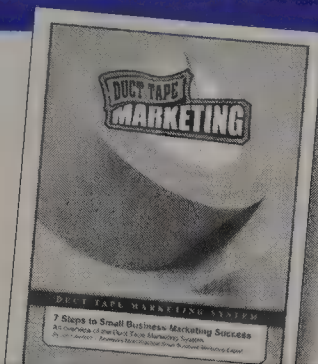
accounting forecast, the actual appraisals by a valuation professional, if already performed, could be used. If the appraisals have not yet taken place, the fair values could be estimated via: appropriate cost indexes; real estate market comparables; replacement cost data Web sites; discussions with construction, insurance and equipment specialists; and other methods. The net adjustments in the acquisition example were an increase in land of \$100,000 and an increase in plant and equipment of \$5.8 million, with a 10-year expected remaining life.

- 4) **Intangible assets.** Statement no. 141(R) also requires the acquirer to recognize all identifiable intangible assets acquired in a business combination. In many cases, the intangible assets of the acquiree are *not* included in the acquiree's pre-combination financial statements. Possible reasons for this include the asset development costs were expensed or written off, or market conditions changed from when a lease or contract was executed to the acquisition date. A valuation professional can help the acquiring company to identify intangible assets and determine their respective fair values.

In the example, the acquiring company identified a royalty agreement intangible asset that was not recorded by the acquiree before the business combination, with an economic useful life and fair value of two years and \$200,000, respectively. A favorable lease was also identified, for which the present value of the favorable lease terms (relative to market conditions at the acquisition date) amounted to \$120,000 and the remaining life of the lease was three years. The acquirer also identified and recognized the fair value of the acquiree's customer contracts and the related customer relationships. The appraisal firm valued this intangible asset at \$500,000 and the estimated useful life at two years.

- 5) **Pre-acquisition goodwill of acquiree.** In the example shown, the acquiree's recorded goodwill of \$1 million was not an identifiable asset and would be

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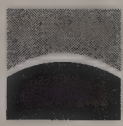
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written off at the acquisition date.

- 6) **Contractual contingency liability.** In the example, the acquiring company determined that a contractual contingency as of the acquisition date should be recorded as a liability and the fair value of the liability was determined to be \$400,000.

After all identifiable assets and liabilities acquired have been assigned fair values, the excess of the total acquisition consideration over the acquisition-date fair values of assets acquired and liabilities assumed should be recognized as goodwill. In the example in Exhibit 2, estimated goodwill amounted to \$2.38 million.

DETERMINING THE POST-COMBINATION INCOME EFFECTS

To forecast the effect of the fair value adjustments on post-combination earnings, the acquiring company needs to estimate the economic useful lives of the assets acquired and liabilities assumed (that is, the time periods over which economic benefits are consumed or otherwise used up and the fair value adjustments are charged or credited to operating results). Valuation professionals can assist the acquiring company in this process. The acquiring company should also estimate the incremental effects of the acquisition for costs other than direct acquisition costs. (Examples include post-combination restructuring costs expected but which the acquirer is not obligated to incur and the amortization of deferred financing costs that will be included in post-combination earnings.) In the example, expected restructuring expense was \$500,000. The pretax income effects of the business combination (excluding unforeseen post-combination asset impairment losses) are summarized at the bottom of Exhibit 2.

MORE REALISTIC EXPECTATIONS

The acquisition method accounting required by Statement no. 141(R) for business combinations is a financial accounting task that

occurs subsequent to the acquisition, and may result in combined earnings substantially different from those anticipated due to the recognition of previously unrecorded assets and/or liabilities, the effect of fair value adjustments for assets acquired and liabilities assumed, and the expensing of incremental acquisition-related costs.

To lessen the probability of major unexpected income effects of the acquisition, the acquiring company's management should consider using an acquisition accounting forecast as discussed above before the acquisition transaction. By integrating the impact of the acquisition accounting forecast and other effects of the business combination with the forecasted operating results (using carrying values) for the acquired company, the acquirer can obtain a more complete picture of post-combination earnings. ♦

AICPA RESOURCES

JofA articles

- "A New Day for Business Combinations," June 08, page 34
- "Refining Fair Value Measurement," Nov. 07, page 30
- "Intangible Value: Delineating Between Shades of Gray," May 07, page 66

CPE

- *The AICPA's Guide to Business Combinations, Goodwill and Other Consolidation Issues*, a CPE self-study course (#735161)
- *What You Need to Know About Accounting for Business Combinations*, a CPE self-study course (#182000)

Publications

Current Accounting Issues and Risks 2008—Strengthening Financial Management and Reporting, a Financial Reporting Alert (#029208)

For more information or to place an order, go to www.cpa2biz.com or call the Institute at 888-777-7077.

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Managing Customer Profitability

Determine which customers are most valuable to your organization.

by Marc J. Epstein, Michael Friedl and Kristi Yuthas

All people may be created equal, but the same can't be said for customers. Everyone knows that some customers are more profitable than others. Conversely, some are downright unprofitable. Knowing which is which is the all-important question.

Despite enormous variations in profitability, many companies continue unprofitable relationships with customers, often pro-

viding them with pricing and service levels identical to those received by the most profitable ones. Why? In most cases, com-

panies simply do not know who the unprofitable customers are. As such, they cannot develop marketing strategies or manage costs accordingly.

Companies don't necessarily need a state-of-the-art database or analytics technology to improve customer profitability. Rather, they can follow a comprehensive approach for measuring and managing customer value called the customer value management cycle (see Exhibit 1). Because of their unique qualifications and abilities, financial managers should take the lead in translating analysis to action and creating the culture of value.

The customer value management cycle has five recurring steps.

To demonstrate the concepts throughout this article, the customer value management cycle is applied to a fictitious company called Sagu Systems. A brief description of Sagu Systems is as follows:

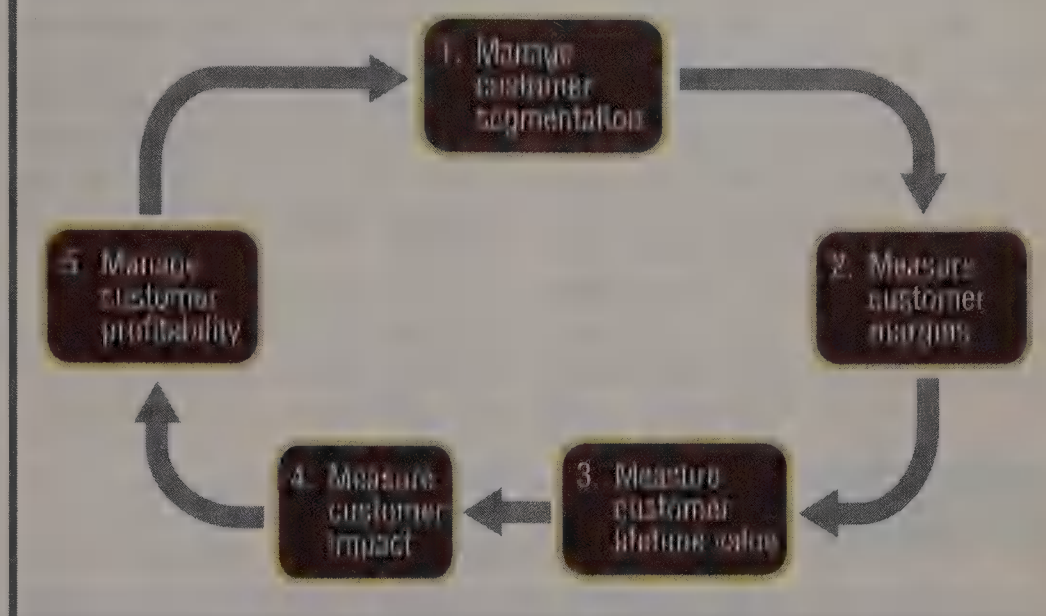
Sagu is a software company located in Chicago. Its primary product, SaguNetwork, is performance monitoring software for corporate networks. Sagu currently sells SaguNetwork and related consulting services to clients. The market for performance management software is expanding rapidly, and Sagu is pursuing an aggressive growth strategy. In an effort to maintain profitability through the growth period, the board of directors has mandated that Sagu analyze the profitability of its customers.

STEP 1: MANAGE CUSTOMER SEGMENTATION

Customer segmentation refers to the process of dividing customers into groups for decision-making purposes. Segmentation allows the company to provide differential advertising or value propositions to different customer groups. Segments are often determined on the basis of customer similarities, such as personal characteristics, preferences or behaviors. Ideally, segments should correlate to behaviors that drive customer profitability.

Segments are continually redefined as the process repeats and customer understanding is refined. For many companies, segments support marketing. Customers can be grouped based on marketing-related characteristics such as expected responses to advertisements or expected

Exhibit 1 The Customer Value Management Cycle



purchasing behavior. As companies move toward rigorous measurement and analysis of customer profitability, they may refine segments as they discover new segmentation parameters.

In the Sagu example, the company begins by analyzing current customers and their purchasing patterns. The analysis results in the two customer segments (see Exhibit 2):

1. In-House Support: customers with in-house IT staff capable of supporting the software

2. No In-House Support: customers lacking in-house IT staff capable of supporting the software

In steps 2, 3 and 4, Sagu calculates the current and expected future value contributions for each segment. In Step 5, Sagu uses the results of this analysis to revise the management of customer value in each segment.

Finally, Sagu returns to Step 1 and restarts the cycle—resegmenting customers based on profitability-related behaviors.

EXECUTIVE SUMMARY

■ **The customer value management cycle presents** a comprehensive model for measuring and managing customer value—it has five recurring steps.

■ **Step 1: Manage Customer Segmentation.** Customer segmentation refers to the process of dividing customers into groups for decision-making purposes. Segments should correlate to behaviors that drive customer profitability.

■ **Step 2: Measure Customer Segment Margins.** At a minimum, companies should measure revenue and gross profit by each customer segment. Allocating

sales, marketing and customer service costs brings this analysis to the next level.

■ **Step 3: Measure Customer Lifetime Value.** The lifetime value of the customer reflects the present value of all expected future flows associated with the customer.

■ **Step 4: Measure Customer Impact.** Two critical sources of hidden customer value are customer influence and customer knowledge. *Customer influence* refers to the influence the customer has, either through intentional action or passive behavior, on other customers, on employ-

ees, or on other stakeholders of the firm. *Customer knowledge* refers to the actionable knowledge that can be gained by the company, either through analysis of customer behavior or through direct customer input.

■ **Step 5: Manage Customer Profitability.** All of the information derived from the measurement of customer value should be analyzed, and actionable tidbits should be derived. This goes far beyond simple reporting of which segments have been more or less profitable. Innovative segmentation and interpretation of the results can uncover areas

where small improvements can yield big improvements in value.

Marc J. Epstein is a professor of management at Rice University in Houston. Michael Friedl is CFO at Crestwood Pacific Group in Newport Beach, Calif. Kristi Yuthas is the information systems management chair at Portland State University. Their e-mail addresses are epstein@rice.edu, michael.friedl@sbi-usa.com and yuthas@pdx.edu, respectively. This article has been adapted from the Management Accounting Guideline Managing Customer Value by Marc J. Epstein and Kristi Yuthas.

STEP 2: MEASURE CUSTOMER SEGMENT MARGINS

Although almost all companies have processes for assessing the profitability of their products, most are far behind in assessing their customers' profitability. Some customers are highly profitable, some are moderately profitable, and some are unprofitable. Many people believe that the 80-20 rule can be applied to customers, which suggests that 20% of the customers are responsible for 80% of the profits. However, results for many companies have been far more extreme.

At a minimum, companies should

measure revenue and gross profit by each customer segment. Allocating sales, marketing and customer service costs brings this analysis to the next level. Selling costs in many organizations vary significantly between customers and segments. Simple changes in the sales compensation plan that more highly rewards profitable deals than less-profitable ones can improve overall profitability.

Invoicing, credit and collection costs might also vary significantly. Changes to pricing and terms tailored to certain segments will also improve profitability.

To be effective, each company should look at the highest-cost line items and determine whether there is a reasonable basis under which to allocate the costs to customers or segments.

Sagu has historically allocated operating expenses based on total revenue of the segment. However, Sagu realizes that operating costs vary across segments as a result of different customer behaviors within the segments. In particular, sales commission costs are associated with software and consulting sales, and technical support costs are associated with the number of maintenance requests submitted by a customer. Sagu separates these costs from other operating expenses and assigns them to the segments based on the actual commissions awarded and technical requests made by each segment. Results are shown in Exhibit 3. Segment profits calculated using the new operating expense numbers are shown in Exhibit 4.

Exhibit 2 Revenue and Expenses by Customer Segment (in millions)

	In-House Support	No In-House Support	Total
Software	60.0	70.0	130.0
Consulting	5.0	30.0	35.0
Total revenue	65.0	100.0	165.0
Cost of goods sold	24.0	40.0	64.0
Gross margin	41.0	60.0	101.0
Operating expenses	31.7	50.0	81.7
Operating income	9.3 14.3%	10.0 10.0%	19.3 11.7%

Exhibit 3 Operating Expenses Allocated by Customer Behavior (in millions)

Operating Expenses	In-House Support	No In-House Support	Total
Sales commissions	4.0	14.0	18.0
Technical support	8.0	21.0	29.0
Other administrative	16.0	18.7	34.7
Total	28.0	53.7	81.7

Exhibit 4 Revised Revenue and Expenses by Customer Segment (in millions)

	In-House Support	No In-House Support	Total
Software	60.0	80.0	140.0
Consulting	5.0	20.0	25.0
Total revenue	65.0	100.0	165.0
Cost of goods sold	24.0	40.0	64.0
Gross margin	41.0	60.0	101.0
Operating expenses	28.0	53.7	81.7
Operating income	13.0 20.0%	6.3 6.3%	19.3 11.7%

STEP 3: MEASURE CUSTOMER LIFETIME VALUE

"Customer lifetime value" (CLV) introduces a new dimension to understanding the value a customer provides. Margin-based calculations focus on the profits realized in the current period as a result of customer purchases. CLV takes a different approach. It treats customers as corporate assets. Companies that use CLV recognize that the costs of attracting a customer represent an investment. They also recognize that the investment can be expected to produce additional future income over time. The lifetime value of the customer reflects the net present value of all expected cash flows associated with the customer.

Companies that use CLV recognize that a customer's profitability in one period isn't necessarily predictive of profitability in other periods, since revenues and costs can vary significantly over time. Thus, CLV values customers on the basis of their expected income-generating potential, rather than solely on their past behavior.

Typically, the customer relationship

begins when the company invests to attract the customer. As the relationship matures, the customer's sales volume may grow and become more profitable. This accumulation should accelerate over time for two reasons. First, the cost to serve the customer should decrease as a percentage of revenues because the customer's knowledge of the company and its products, together with increasing trust, may lead to reductions in promotion, training and relationship maintenance costs. Second, as the relationship matures, the customer may be more likely to respond to cross-selling or upselling initiatives.

Thus, by expanding the notion of profitability to incorporate profits over the entire lifetime of the customer relationship, marketers have significantly enhanced their ability to effectively manage customers for enhanced profitability. Calculating CLV requires an understanding of customer retention rates in addition to purchasing patterns and costs for each segment, then discounting the values to the present. Simply put, CLV is the present value of profits over the expected lifetime of the customer or segment.

This analysis can significantly affect a company's view of a segment with small initial purchases but with a long expected relationship, versus a segment with a larger initial purchase but limited repeat potential.

Sagu, for example, armed with information about current profitability, can begin to assess the long-term value of each customer segment. To do this, the company will estimate growth in profits for each segment and change in size of each segment as Sagu loses old customers and adds new ones over time. Exhibit 5 shows the CLV calculations for its In-House Support and No In-House Support customer segments during the coming six years. CLV shows the value of a segment's customers to Sagu today, based on the discounted value of anticipated future profits. To simplify the example, it is assumed that the operating margins of both segments are equal in year one. Income growth and retention

rates are held constant over the six-year period.

Sagu's CLV analysis provides a new perspective on the relative value of these customer segments. The In-House Support segment is expected to grow at a 10% rate, as a result of additions in software users to existing software packages.

the expected profitability of their customers. They can provide excellent estimates of the value that each customer and segment provides to the company through normal purchasing and usage.

But these approaches often fail to capture some potentially significant sources of value customers can provide to the

Customer lifetime value (CLV) is the present value of profits over the expected lifetime of the customer or segment.

Discounting each year's anticipated profits back to the present using a 10% rate results in an expected lifetime value for the segment of \$34.7 million. The CLV analysis tells a different story about the relative value of the No In-House Support segment. The No In-House Support segment shows a loss of market size, due to a low customer retention rate, and a correspondingly lower lifetime value as a result of this attrition.

STEP 4: MEASURE CUSTOMER IMPACT

The final component of value provided by the customer is customer impact. Activity-based costing and customer lifetime value have enabled companies to make great advances in understanding

company. Of course, profits resulting from current or future sales to customers are the most significant source of value for most customer segments. But value can be created (or destroyed) by customers in many other ways that fall outside the reach of CLV.

Two critical sources of hidden customer value are customer influence and customer knowledge. *Customer influence* refers to the influence the customer has, either through intentional action or passive behavior, on other customers, on employees, or on other stakeholders of the firm. *Customer knowledge* refers to the actionable knowledge that can be gained by the company, either through analyzing customer behavior or through direct customer input. Through their interactions ➤

Exhibit 5 Customer Lifetime Value (in millions)

In-House Support Customers							
	Year						
	1	2	3	4	5	6	
Operating Margin (5% Growth)	6.5	6.8	7.2	7.5	7.9	8.3	
Retention Rate Existing	1.10	1.10	1.10	1.10	1.10	1.10	
Gross Value of Profits	7.2	7.5	7.9	8.3	8.7	9.1	\$48.7
Discount Factor	0.91	0.83	0.75	0.68	0.62	0.56	
Net Present Value of Profits	\$6.5	\$6.2	\$5.9	\$5.6	\$5.4	\$5.1	\$34.7
No In-House Support Customers							
	1	2	3	4	5	6	
Operating Margin (5% Growth)	6.5	6.8	7.2	7.5	7.9	8.3	
Retention Rate Existing	0.91	0.91	0.91	0.91	0.91	0.91	
Gross Value of Profits	5.9	6.2	6.5	6.8	7.2	7.5	\$40.1
Discount Factor	0.91	0.83	0.75	0.68	0.62	0.56	
Net Present Value of Profits	\$5.4	\$5.2	\$4.9	\$4.7	\$4.5	\$4.2	\$28.9

with the product, with the company and with other stakeholders, customers can affect value in numerous ways, ranging from identifying small errors in technical documentation to significantly influencing the brand's image.

Although influence and knowledge contributions will always be difficult to define and measure, even rudimentary estimates of direction and magnitude can

ally all of the customer impact. These loyal clients are very well-known and highly respected in the software industry. Sagu estimates that they are responsible for a significant portion of the client growth that contributes to favorable retention rates—both through reputation and through referrals. In addition, these customers are very knowledgeable, and are used as testing sites for new software

Value can be created (or destroyed) by customers in many other ways that fall outside the reach of CLV.

be valuable. To ignore such contributions is akin to assigning them a value of \$0, which is certainly incorrect, and may rob the company of the opportunity to investigate these increasingly important aspects of customer value.

Over time, companies that think creatively about a full range of sources of customer value gradually improve their understanding of these sources, and their ability to assess and measure them. Embarking on this process opens new avenues for innovation in products and methods, and generates new options for maximizing long-term customer value.

For Sagu to supplement its CLV analysis, the company estimates the potential impact of each customer segment. Through this analysis, Sagu realizes that a small number of its large clients in the In-House Support segment generate half the revenue of this segment, and virtu-

ally all of the customer impact. These loyal clients are very well-known and highly respected in the software industry. Sagu estimates that they are responsible for a significant portion of the client growth that contributes to favorable retention rates—both through reputation and through referrals. In addition, these customers are very knowledgeable, and are used as testing sites for new software

enhancements and sounding boards for technical planning personnel. The estimated benefits in this scenario include: (1) influencing/referring other customers and (2) testing and improving software prior to release. The sum of the discounted values of these benefits is expected to be \$6.5 million, as shown in Exhibit 6.

STEP 5: MANAGE CUSTOMER PROFITABILITY

This is where the proverbial rubber meets the road. All of the information derived from the measurement of customer value should be analyzed, and actionable tidbits should be derived. This goes far beyond simple reporting of which segments have been more or less profitable. Innovative segmentation and interpretation of the results can uncover areas where small improvements can yield big

improvements in value. For example:

- A segment where technical support costs are disproportionate could drive improved documentation.
- Segments with lower expected customer life could reveal a lack of attention from the customer service team.
- A segment with high revenues but low profits might indicate the need to re-tool the sales compensation scheme to shift incentives to increase focus on profits.

Sagu has learned a great deal about the profitability of its segments through this analysis and will use this information to more effectively manage the value of these segments. First, through the Step 2 analysis of customer margins, Sagu has learned that the No In-House Support segment has higher operating costs than were apparent under the former cost allocation system. In part, this was the result of high maintenance costs for these clients.

To address this issue, Sagu decided to change the maintenance agreement it provides to customers. In the future, customers will be provided with a limited number of technical support hours and will be charged for any additional time.

Through the CLV analysis in Step 3, Sagu learned that the No In-House Support segment was expected to show profitability losses over time, due to low profitability growth and retention rates over time.

As a result of this analysis, Sagu interviewed key clients in the segment to determine reasons for the decline. These clients suggested that they needed additional consulting support to help them make the best use of their software. Sagu has increased efforts to inform customers about available consulting services, and anticipates both growth in consulting revenues and increased retention in the segment as a result.

Finally, in Step 5, Sagu analyzed customer impact and realized that the customers with the greatest impact on both attracting new customers and on gaining valuable knowledge were a subset of their In-House Customers. This

Exhibit 6 Added Value of High-Impact In-House Customers (in millions)

Impact Calculation	High-Impact In-House Customers					
	Year					
	1	2	3	4	5	6
Value of referrals	\$1.0	\$0.7	\$0.6	\$0.5	\$0.4	\$0.3
Value of knowledge gained	0.8	1.2	0.9	0.8	0.8	0.8
Discount factor (10%)	0.91	0.83	0.75	0.68	0.62	0.56
Current value of impact	\$1.6	\$1.6	\$1.1	\$0.9	\$0.7	\$0.6
Total Impact						\$6.5

group of clients consists of highly knowledgeable users, who contribute product and service knowledge to Sagu, and also encourage other clients to adopt the software—either through direct referrals or through reputation.

Through the customer impact analysis, Sagu has recognized the high value of these customers to the firm and has initiated new policies designed to pro-

them with some prestige and the opportunity to interact directly with other high-powered users to share insights and strategies with each other and with Sagu.

CONCLUSION

By measuring the profitability of segments and managing customer relationships based on customer value, both the

a company will gain invaluable knowledge and be able to put it to work for the mutual benefit of all stakeholders. ♦

Companies that think creatively about a full range of sources of customer value gradually improve their understanding of these sources.

vide special benefits to these customers. They will receive a discounted rate for adding software seats, which is expected to grow profits more rapidly and strengthen customer loyalty. And they will be invited to sit on a newly formed user advisory board, which will provide

customer and company win. Orienting an organization around measurement and management of customer profitability can take place immediately, or it can take many periods, implementing these strategies one step at a time, and adjusting and refining along the way. Over time

AICPA RESOURCES

Management Accounting Guidelines

- *Managing Customer Value*
- *Managing Opportunities and Risks*
- *Impacting Future Value: How to Manage your Intellectual Capital*

AICPA members can download all Management Accounting Guidelines for free at <http://fmcenter.aicpa.org/Resources/Management+Accounting+Guidelines/Available+Management+Accounting+Guidelines.htm>.

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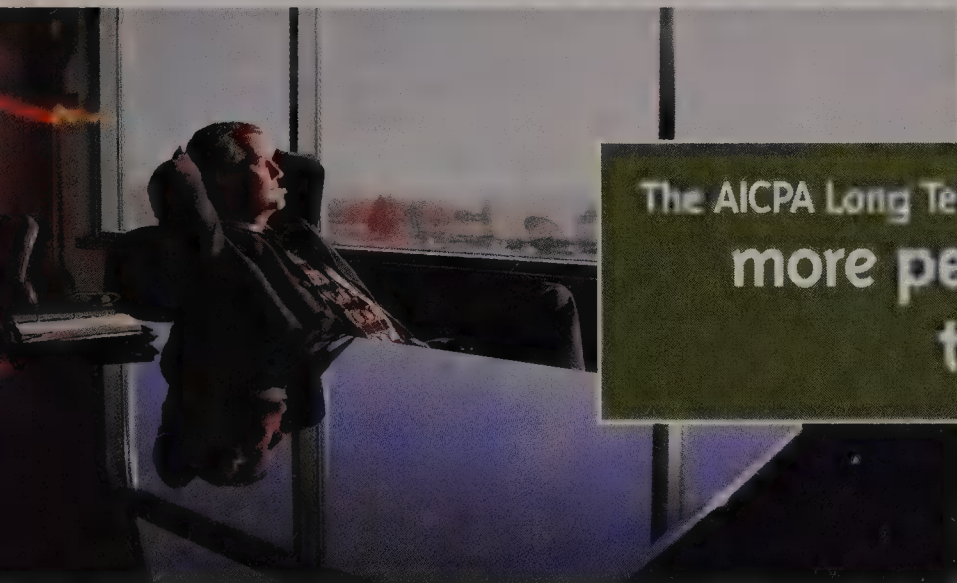
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What's more, your Social Security Disability benefits won't be reduced because of your LTD benefits.

Additionally, participants in the LTD Plan are eligible for cash refunds, paid out of premium refunds received from Prudential, which significantly reduce the cost of coverage. Although not guaranteed, cash refunds have been paid every year since 1988.

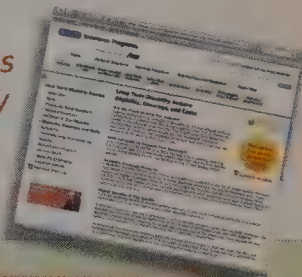
Choose your waiting period

Participants in the LTD Plan can decide when they will receive their benefits: The 13-week waiting period allows you to receive your disability benefits sooner, while the 26-week waiting period has a lower cost to you.

Since returning to work is an important milestone in your recovery, a Rehabilitation Program is an important tool in getting you back to work. You'll continue to receive a monthly benefit, at a reduced rate, while you return to work and earn an income. Participation in the Rehabilitation Program is completely voluntary, and can even pay for approved vocational training.

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American Institute of Certified Public Accountants Insurance Trust



Test-Driving the Codification

Accounting research on the fast track

by Caroline O. Ford and C. William Thomas

In January, FASB released the FASB *Accounting Standards Codification* (ASC or codification). The codification simplifies the classification of accounting standards by restructuring all authoritative U.S. GAAP for nongovernmental entities into one online database under a common referencing system. The codification is a first step in organizing U.S. accounting standards for convergence with IFRS.

When it becomes authoritative, which is expected to happen in April, the codification will become the single source of authoritative U.S. accounting standards for nongovernmental entities, superseding all then-existing non-SEC accounting and reporting standards. A summary of the content and structure of the codification was featured in the *JofA* earlier this year ("Framing the Future," May 08, page 40). This article continues with a more detailed discussion of the structure of the codification and Web-based research system, which offers several options for accessing, viewing and using its contents.

A brief accounting research case study

in this article offers a firsthand look at how to use the codification research system. We compare the results of research using the new system with those of traditional research methods.

We encourage readers to test-drive the system while they read the article to better understand the system and experience its benefits firsthand. FASB is not charging for using the system now but has not said whether that will change after the codification becomes authoritative. Register to use the codification at <http://asc.fasb.org> and consider commenting before FASB closes the verification period on Jan. 15.

TIERED, TOPICAL STRUCTURE: AREAS AND TOPICS

The codification is organized in a tiered structure. Information is organized into eight areas, ranging from industry specific to general financial statement matters. Within each area are topics, subtopics, sections, subsections and paragraphs, where details of the technical content reside.

At the topic and section levels, the codification material correlates to IFRS. The codification topical organization is expected to ease the convergence of U.S. GAAP and IFRS standards.

Each area represents a collection of related topics, which are designated with 3-digit topic codes. The areas are: presentation; assets; liabilities; equity; revenue; expenses; broad transactions; and industry.

Topics in the "Presentation" area relate only to general presentation matters and do not address recognition, measurement, and de-recognition issues. Within the five financial statement account areas—from assets through expenses—various types of

financial statement accounts are treated as separate topics. Topics in the "Broad Transactions" area relate to multiple financial statement accounts and are generally categorized by type of transaction. As the name implies, topics in the "Industry" area deal with transactions that are unique to specific industries or types of activities.

SUBTOPICS

Subtopics represent two-digit subsets of a topic and are generally distinguished by type or by scope. Subtopics unique to a topic use classification numbers between 00 and 99. Topics contain an overall subtopic, which is always coded 10. Unique or incremental subtopics are assigned higher numbers. Industry topics may contain subtopics that mirror general topics where applicable.

SECTIONS

Sections represent the nature of the content within a subtopic. Every subtopic uses the same sections, unless there is no content for a particular section within that subtopic. See the sidebar "Standard Section Content Within Codification" for the standard content specifications for sections.

Sections that cover SEC disclosure requirements for public companies are designated with the prefix "S." The codification does not contain the entire population of SEC rules, regulations, interpretations and staff guidance. In particular, it excludes con-

tent related to matters outside the basic financial statements, such as management's discussion and analysis, auditing and independence matters. The codification does not replace or affect SEC guidance as it does with FASB and other standards. SEC content is expected to be updated periodically as SEC rules change. Users should always refer to the SEC Web site for the most recent updates regarding SEC rules and regulations.

SUBSECTIONS AND PARAGRAPHS

Subsections occur only in a limited number of cases. They further segregate content of a particular section. Each section

related to acquisition, development and construction arrangements.

CLASSIFICATION CODES

Unlike any previous GAAP references, the codification follows an established pattern. The hybrid classification system is XXX-YY-ZZ-PP, where XXX = topic, YY = subtopic, ZZ = section, and PP = paragraph.

USING THE CODIFICATION RESEARCH SYSTEM

Navigation within the codification research system can be accomplished four ways: browsing by topical structure, cross-referencing original standards and the codification, searching, or by using a "go to"

The codification topical organization is expected to ease the convergence of U.S. GAAP and IFRS standards.

has at least one general subsection. Subsections are not numbered. They differ from a paragraph heading in that the system provides a feature to combine all subsection content for a topic.

For example, the "Receivables" topic—"Overall" subtopic—"Overview and Background" section (ASC 310-10-05) includes a subsection for acquisition, development and construction arrangements. This allows CPAs doing research to combine all content

feature. The system's home page offers tutorials that include audio and animated screens demonstrating how to navigate the codification research system.

Browsing by topic, FASB's intended method of navigation, requires the user to first click on a link from an always-present list of areas, followed by topics and another click to a subtopic link. A table of contents displays sections and allows the user to expand the view to list

EXECUTIVE SUMMARY

■ **FASB released the FASB Accounting Standards Codification in January.** The codification simplifies the classification of accounting standards by restructuring all authoritative U.S. GAAP for nongovernmental entities into one online database under a common referencing system. It's a first step in organizing U.S. accounting standards for possible convergence with IFRS.

■ **The codification is organized in a tiered structure.** Information is organized into eight areas, ranging from industry specific to general financial statement matters.

Within each area are topics, subtopics, sections, subsections and paragraphs, where details of the technical content reside. At the topic and section levels, the codification material correlates to IFRS.

■ **Unlike any previous GAAP references,** the codification follows an established pattern. The hybrid classification system is XXX-YY-ZZ-PP, where XXX = topic, YY = subtopic, ZZ = section, and PP = paragraph.

■ **Navigation within the codification research system** can be accomplished four ways: browsing by topical structure, cross-

referencing original standards and the codification, searching, or by using a "go to" feature.

■ **Browsing by topic—FASB's intended method—**requires the user to click on a link from an area list, followed by topic and subtopic. A table of contents displays sections and allows the user to expand the view to list all subsections and paragraphs. A "breadcrumb" navigation stream is listed at the top of the page for reference and navigation.

■ **The cross-reference feature links original standards** with the codification either by standard or

by codification. After first choosing a standard type from a dropdown menu of 19 sources and choosing the standard number, the system generates a report linking original source paragraph numbers to codification paragraphs.

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Standard Section Content Within Codification

XXX-YY-00 Status
XXX-YY-05 Overview and Background
XXX-YY-10 Objectives
XXX-YY-15 Scope and Scope Exceptions
XXX-YY-20 Topical Definitions—Glossary
XXX-YY-25 Recognition
XXX-YY-30 Initial Measurement
XXX-YY-35 Subsequent Measurement
XXX-YY-40 Derecognition
XXX-YY-45 Other Presentation Matters
XXX-YY-50 Disclosure
XXX-YY-55 Implementation Guidance and Illustrations
XXX-YY-60 Relationships
XXX-YY-65 Transition and Open Effective Date Information
XXX-YY-70 Links to Grandfathered Material
XXX-YY-75 XBRL Definitions

all subsections and paragraphs. A “breadcrumb” navigation stream is listed at the top of the page for reference and navigation.

The cross-reference feature links original standards with the codification either by standard or by codification. Queries by standard allow users to determine where original standard content is located within the codification. After first choosing a standard type from a dropdown menu of 19 sources and choosing the standard number, the system generates a report linking original source paragraph numbers to codification paragraphs. Clicking on the links within the report takes users to original standards and/or paragraphs in the codification.

Searching “by codification” follows the same pattern, except codification topics, subtopics and/or section numbers are entered to generate a report linking to related original standard paragraphs. As users familiarize themselves with the system, the cross-reference feature will likely be their preferred choice of navigation. However, it is unclear how long this feature will remain once the codification becomes effective.

The search feature within the codification research system is similar to other Boolean operator (key character) search engines. Search results can be narrowed by related terms or by area. The “Go To” feature allows advanced users to jump to a requested document location within the system, as long as the researcher knows at least the topic number at issue.

RESEARCHING A REVENUE RECOGNITION ISSUE: COMPARING OLD AND NEW

The following discussion compares the research process using a traditional research system versus the codification research sys-

tem. The scenario is a Trueblood Case Study reproduced with permission from the Deloitte Foundation. The question at issue is how the business, Lighthouse, should recognize revenue for sales of its devices and service.

Lighthouse is a provider of locating services to the shipping industry. Lighthouse’s Ship Finder service is a one-way messaging service that routes messages from the ships at sea to the shipping company’s offices. These messages provide the shipping company with detailed information related to ship location, speed and current local weather. Lighthouse must install a dedicated hardware unit or device on the ship before the Ship Finder service can be used. Customers generally sign two contracts, one governing the sale of devices and the other governing the provision of the service.

Service contracts generally span 12 months and are billed monthly. The services are priced at standard rates, although discounts are offered depending on the number of devices sold. The devices also have been sold at a discount. However, the discount is based on the number of units purchased (or to be purchased) and does not appear to be unreasonable.

Standard pricing for the devices and service is as follows:

<u>Product or Service</u>	<u>Price</u>
Ship Finder Device	\$10,000 per unit, MSRP
Ship Finder Service	\$300 per month, per unit

The Lighthouse devices are made to be used exclusively with the Lighthouse services and, currently, no competitor makes devices that work with the Lighthouse services. Customers may cancel the service at any time. However, amounts paid related to the devices are nonrefundable. Payments for the devices are due upon completion of the installation and final acceptance by the customer.

TRADITIONAL RESEARCH SYSTEM

To illustrate the traditional research system method, we used the Financial Accounting Research System (FARS) (www.fasb.org/fars), as well as the SEC Web site as sources of evidence. The research process described below, however, is applicable to most traditional research systems oriented to the GAAP hierarchy.

First, a keyword search or reference to a topical index for such keywords as *revenue recognition*, *right of return*, *service contracts*, and/or *multiple deliverables* identified a vast number of authoritative sources from various levels of the GAAP hierarchy. For example:

<u>Keyword</u>	<u>Search Results (abbreviated)</u>
<i>Revenue recognition:</i>	ARB 43; APB Opinion 10; FAS 48; FAS 111; FTB 90-1; SAB Topic 13; SAB 101; SAB 104
<i>Service contracts:</i>	FIN 46R; EITF 97-2; FAS 141R; EITF 08-1; EITF 99-19
<i>Multiple deliverables:</i>	EITF 01-4; EITF 00-21; EITF 00-3; SAB 104; SAB 101

Actual search results far exceeded the abbreviated list above.

Wading through unrelated search results created an inefficient research process. Adding to the inefficiency, the various levels of the GAAP hierarchy in the search results required the researcher to spend considerable time and effort referencing each related result. Because the GAAP hierarchy places a higher significance on level A sources (see GAAP hierarchy in FASB Statement no. 162), the search results from the higher levels are investigated first. However, the lower levels, such as EITF results from level C, cannot be ignored. They may be relevant for the specifics of Lighthouse's accounting issue.

Even after narrowing the search when possible, the researcher spent valuable time reading authoritative sources that ultimately did not apply to this case. Finally, the researcher narrowed the applicable sources to Lighthouse's revenue recognition issue to the following: SAB 101, EITF 00-21, ARB 43 and APB Opinion 10. These sources provide the foundation for the two accounting alternatives:

Alternative 1. The device and service agreements represent a single unit of accounting, and both elements should be recognized as the service is provided.

Alternative 2. The delivery of the devices represents a separate earnings process and should be recognized once the devices are delivered, installed and accepted by the customer.

Advocates of alternative 1 point to the fact that the service cannot be used without the device, and the device alone has no function. The three criteria, outlined in EITF 00-21, paragraph 9, to determine whether a delivered item is a separate unit of accounting, are not met. Therefore, EITF 00-21, paragraph 10, indicates that the device revenue should be combined with the undelivered item (services) to determine the appropriate recognition of revenue. The device revenue should be recognized over the service period. SAB 101, now codified in SAB Topic 13, reiterates the need to defer the device revenue until service is provided (see SAB Topic 13 A(3)(c)).

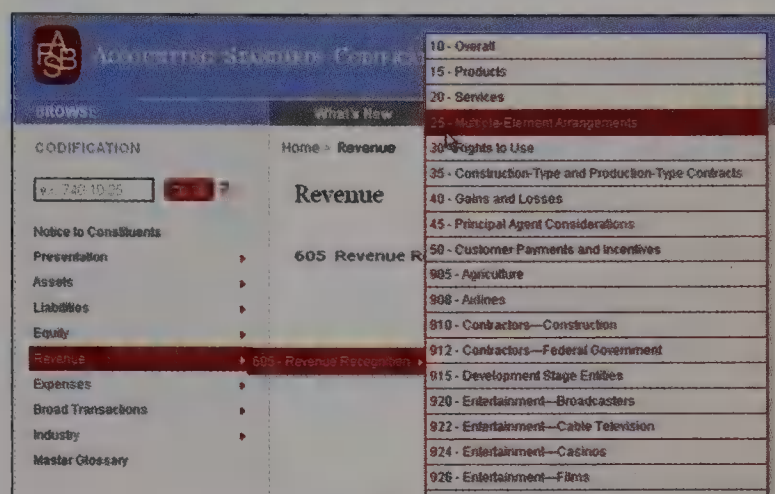
Alternative 2 advocates, on the other hand, believe that the device and service are separate units of accounting. They note that Lighthouse prepares separate contracts for the device and service, and amounts paid for devices are nonrefundable even if service is canceled. Revenue recognition for devices does not depend on customers using the service. Therefore, device revenue should be recognized at the time the transaction is completed because it is realized or realizable and earned, as noted in ARB 43, chapter 1A, and APB Opinion 10, paragraph 12.

To complete the research process, the researcher must draw a conclusion and communicate it to the appropriate person(s).

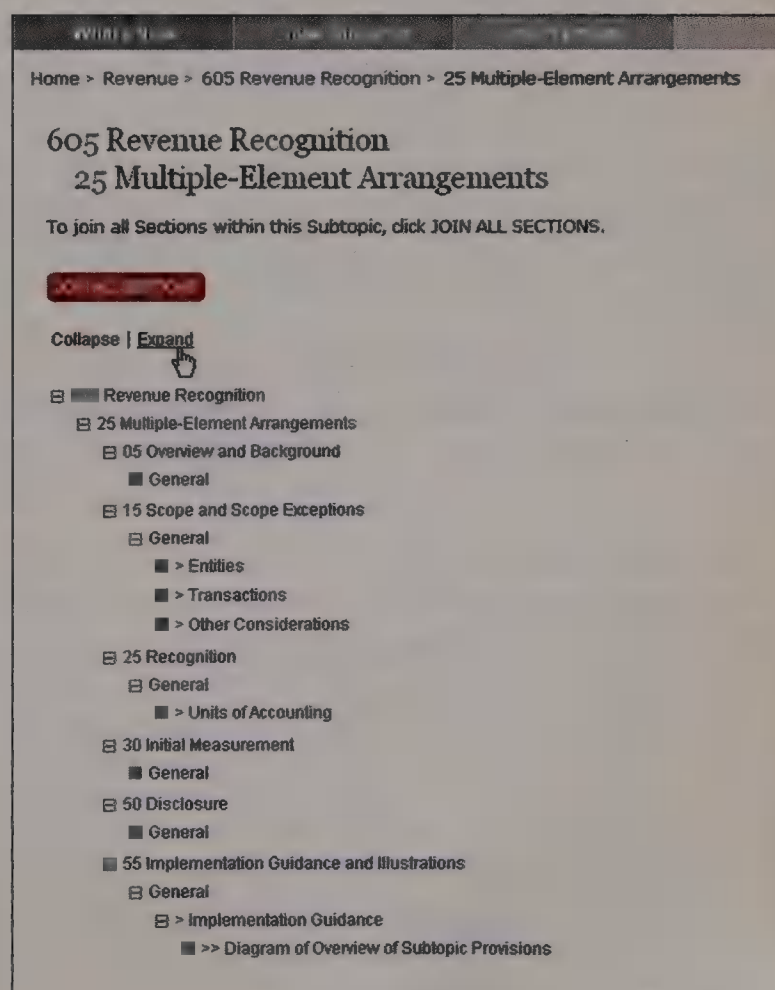
FASB CODIFICATION RESEARCH SYSTEM

Rather than beginning the research process with a general keyword search, using the codification research system, the researcher began by browsing the main areas list, which always appears on the left-hand side of the screen. The researcher chose the area "Revenue" and the corresponding topic "Revenue

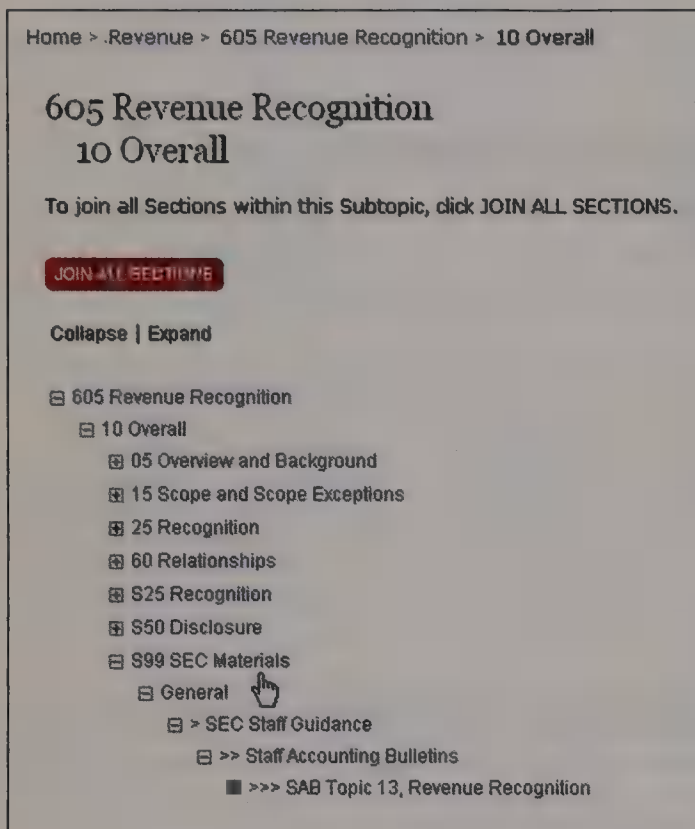
Recognition" (605) and then browsed the adjoining subtopic links (see screenshot below), choosing the subtopic "Multiple-Element Arrangements (25)."



The table of contents for 605-25 displayed the various related sections, subsections and paragraphs. The "Expand" function allowed the researcher to quickly and easily view each specific area within 605-25. From there, the researcher could choose one specific section/subsection/paragraph to explore. The researcher also used the "Join All Sections" (see screenshot below) function to read each section/subsection/paragraph consecutively, rather than just one source at a time.



In addition to exploring 605-25, the researcher investigated additional subtopics under the main topic “Revenue Recognition” (605), including the “Overall” subtopic 10 (see screenshot below), subtopic 15 (Products), and subtopic 20 (Services). Each subtopic falls under the topic heading “Revenue Recognition” (605). For each subtopic chosen, the researcher reviewed related SEC material, which is listed along with all other sections but prefaced with the letter “S.”



While the alternatives regarding Lighthouse’s revenue recognition issue are the same, the process using the codification research system is significantly streamlined, reducing time and resource requirements. Note that this method did not require the researcher to investigate various levels of GAAP literature, determining which was most authoritative, nor did the researcher have to use literature from multiple sources. Instead, the alternative was formed after researching within one main topic (605) and two subtopics (605-25 and 605-10).

The authoritative guidance used to form alternative 1 using the traditional method (EITF 00-21, paragraphs 9 and 10, and SAB Topic 13) is worded identically in the codification research system and can be found at FASB ASC 605-25-25-5, 605-25-25-6, and 605-10-S99, respectively. This can be verified using the “Printer-Friendly with sources” function within the codification research system. This option, which may be available only during the verification period, shows the original source of codification material in parentheses after the codification paragraph.

The wording in the authoritative guidance used to form alternative 2 (ARB 43, APB Opinion 10) was also identical to that within the codification research system (FASB ASC 605-10-25-

3). In forming the second alternative, note that only one section/subsection was needed.

FEEDBACK

We introduced the codification in a senior-level undergraduate university course in accounting research and communication. We required 75 students to research six accounting cases similar to the one used above using both FARS and the codification research system. Students unanimously preferred the codification research system for reasons including ease of navigation and the benefits of having multiple ways to search.

For its part, FASB has been gathering comments on the system since the verification period began Jan. 15. FASB has received more than 700 comments from roughly 300 individuals, according to Christine Klimek, communications manager for the Financial Accounting Foundation. The comments are not public, but Klimek said most of them are content-related rather than general or system-related and that overall the feedback has been “extremely positive.”

As CPAs adjust to the codification and research system, there are two potential downsides—the obvious learning curve and costs associated with redesigning firms’ research systems. We believe the learning curve associated with using the codification will be short. For reasons stated earlier, such as the cross-reference feature and topical index, the codification makes it fairly easy for researchers to learn the new system.

While this article provides exposure to the codification, there is no substitute for practice. We recommend readers register at <http://asc.fasb.org>, retrace the research steps outlined in the short case study used in this article, and see firsthand the advantages of using the codification research system over traditional research systems. Additionally, we encourage readers to explore the codification by Jan. 15, FASB’s deadline for comments, and provide feedback to FASB about any inadvertent changes to GAAP that may have occurred as a result of the codification process. ♦

AICPA RESOURCES

JofA article

“Framing the Future,” May 08, page 40

Publication

FASB Codification Developments—2008: Strengthening Financial Management and Reporting, a Financial Reporting Alert, offers an overview of the codification project and case study examples (#029209)

CPE

■ *Understanding FASB’s Accounting Standards Codification*, a CPE on-demand Web event (#780131)

■ *Navigating the New FASB Codification: Research Real Life Accounting Issues*, a CPE self-study course (#745600)

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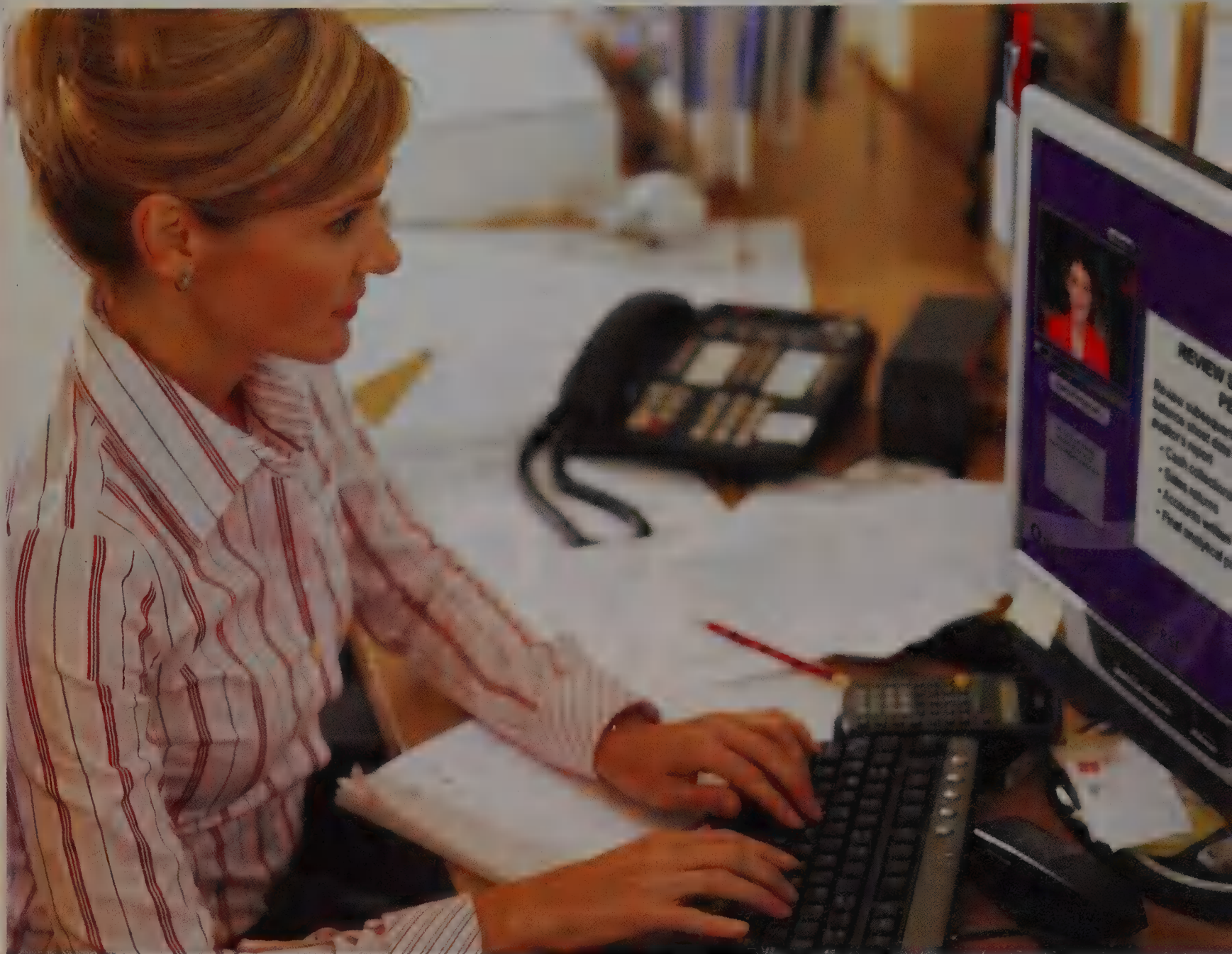
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Six Lessons for Your First 100 Days

New finance execs must move swiftly to learn the ropes, set the pace.

by Rick Telberg

Finance executives are increasingly finding themselves in the middle of corporate decision-making and responsibility. For newly-appointed CFOs and finance managers, success is no small feat — your first 100 days are critical.

With the pressure on, newly-appointed finance managers want to make their mark early, and, according to a recent survey by global management consulting firm McKinsey & Company, there are some activities that should make nearly every finance executive's short list of priorities.

During the first 100 days, 75% of new finance executives initiated, or developed a plan to initiate changes in the department's core activities.

One of the most critical activities during an executive's first 100 days is the gaining of and understanding of what drives your company's business, whether it is how your company makes money or its returns on invested capital. At the same time, a CFO must also consider potential ways to improve such drivers.

In the survey, McKinsey asked established executives about their first 100 days on the job, their successes, failures and lessons learned.

1. Get to know the business units. Make them part of a strategy and value audit by meeting with business unit leaders for information on product lines and markets.
2. Talk with customers, investors and the company's professional services providers for external perspectives.
3. Understand what your CEO wants from you. Nearly four-fifths of the finance executives in the survey said that their CEOs expected them to serve as active members of the senior management team, contribute to the company's performance and make the finance organization efficient.
4. Know your team. It is also critical that CFOs strengthen the core finance team and establish a well-functioning finance department, because having disparate systems and processes or unwieldy organizational structures can hamper a company's performance.

According to those surveyed, during the first 100 days about three-quarters of the new finance executives initiated, or developed a plan to initiate, changes in the department's core activities. In their reviews, for example, finance executives assessed the reporting structure, evaluated the fit and capabilities of their finance staffers and identified any inefficiencies in their key systems.

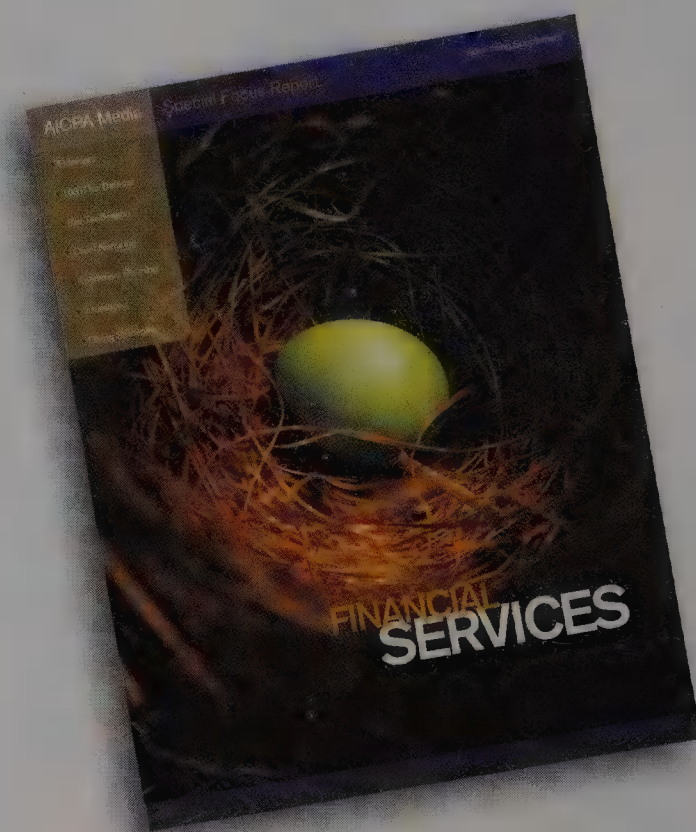
The results: Finance executives could gauge how much energy they would need to invest in the finance organization during their first six to 12 months in their role and fix any problems that arise.

Furthermore, those finance executives who joined a company during or just after a turnaround are more likely to have been required to put in place a formal plan of action.


5. Get a mentor. You'll need a sounding board. Many finance executives — 32 percent, to be precise — said they didn't have a mentor. And 46 percent said that the CEO was their mentor. While having the guidance of the CEO is undoubtedly helpful, many respondents said it was difficult discussing some of the challenges with the boss. Newly-appointed CFOs may want to consider joining roundtables or other forums to build networks and share ideas.
6. Stay focused. McKinsey suggests that newly-appointed finance executives supplement their day-to-day activities with no more than three or four major change initiatives. Remain focused on those initiatives and repeat the message over and over — internally to staff and externally to stakeholders.

There's no doubt that, for a newly-appointed finance executive, winning the support and respect from other corporate officers doesn't always happen overnight, but being able to understand where value is created and to develop a strategy for influencing ongoing performance management will put you on the road to success.

Rick Telberg is editor-at-large for the AICPA *Insider*™ E-Newsletter Group. Views expressed do not necessarily represent those of the AICPA or the *Journal of Accountancy*.



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Executive Roundtable

Here's the equation for today: Recession + Financial Meltdown = ? What does this mean for CPAs and financial executives? To help you understand both the challenges and rewarding opportunities of a career in finance and accounting, the AICPA Custom Media Solutions team invited thought influencers to share their insights on these hot button topics. Joining us this month (listed alphabetically) are: **David C. Hisey**, EVP and Chief Financial Officer, Fannie Mae; **John Hudson**, CPA, President, Hudson Consulting LLC; **Denise Probert**, MPA, CPA, Vice President of CPA Education, Kaplan Schweser; **Thomas Vucinic**, CPA, President, Becker Professional Review; and **Carl Wright**, CEO, Stephen James Associates.



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CPA, President,
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Thomas Vucinic
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Carl Wright
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Stephen James Associates

Panelists, what is the most surprising aspect of today's job market for financial professionals, particularly CPAs?

David Hisey (Fannie Mae): One of the most under-reported aspects of today's job market for financial professionals is the importance of gaining an understanding of the company as a whole, not just one department. They have to understand how a company operates, as well as be able to communicate accounting and financial information effectively to a diverse group of key stakeholders.

John Hudson (Hudson Consulting LLC): A job search conducted today is different from a job search just a few years ago. More, CPAs are looking to online career centers as an integral component of a job search. Online career centers are like "dating services" between job seekers and potential employers. They connect recruiters with jobseekers based on a match of skills, abilities and opportunities.

Denise Probert (Kaplan Schweser): Today's job market lacks well-rounded CPAs. Technical knowledge and skills are essential, but the market has an insatiable appetite for people with strong communication and critical-thinking skills.

Thomas Vucinic (Becker Professional Review): During tough economic times, with unemployment on the rise, the most surprising under-reported aspect of today's job market is the number of job opportunities that still exist for CPAs. CPAs continue to "wear many different hats," from Forensic Accounting with the FBI to Environmental Accounting within the oil and gas industry.

Carl Wright (Stephen James Associates): I'd draw your attention to two distinct items:

1. CPAs are not passing the CPA exam as early in their careers as they did 10 years ago; particularly those in public accounting. Ten years ago, many public accountants were pushed out of the Big 4 (Big 6 then)

firms if they didn't pass the exam within the first two years. Public accountants certainly didn't get promoted to the senior or in-charge level prior to passing the exam as we see happening now; and

2. The tenure of financial professionals, particularly CPAs, seems to have shortened considerably over the years.

What are the hot CPA specialties today and why?

Hisey: The CPAs of today and tomorrow need to play a much larger role in leading and helping to execute business strategy. This demands strong technical experience in the following areas: audit, financial auditing, financial analysis, financial planning, financial reporting.

Probert: Internal audit continues to grow post Sarbanes-Oxley implementation.

Vucinic: The U.S. Securities and Exchange Commission has mandated that all U.S. companies adopt International Financial Reporting Standards by 2014. Furthermore, the SEC may allow certain companies to file their financial statements using IFRS as early as 2010. This will create huge opportunities for anyone with knowledge of IFRS. In addition, forensic accounting and risk management remain hot areas for CPAs as well.

Wright: I would also add non-reporting, but purely in technical accounting research positions in public as well as venture or investor-backed companies.

Which specific skill-sets do CPAs need for success tomorrow (think both hard and soft skills)?

Hisey: They need to have good client-facing skills and to be solutions-oriented in their approach.

Hudson: Historically, a CPA's rise in an organization has been a function of their detailed technical and analytical skills. These are always important but not to the exclusion of seeing the big picture. Successful CPAs in the future need to seamlessly integrate their detailed technical/analytical skills with their more strategic and conceptual skills.

Probert: As the SEC moves towards adopting IFRS, CPAs will need to develop strong skills in these standards. This will require an education that provides a mastery of the international standards as well as a strong understanding of the appropriate implementation procedures.

Vucinic: However, many individuals entering the profession underestimate the importance of soft skills. An effective CPA needs to work well with clients, team members, supervisors and must, therefore, have excellent presentation, communication, and team-building skills. Further, effective CPAs need to exhibit a healthy skepticism and the ability to diplomatically challenge the status quo.

Wright: For small- and mid-sized corporate growth, strong corporate and personal tax experience blended with audit experience is best. A balanced sense of urgency, confidence and common sense are the most important soft skills for success. In addition, as the U.S. moves in the IFRS direction, strong communication and multi-lingual skills will become more important as well.

What are some useful career resources that many CPAs may not be aware of?

Hisey: Some resources that are not always tapped into include public accounting firm alumni associations and networking Web sites such as LinkedIn. In addition, another useful career resource that should always be a focus of CPAs, is the importance of identifying strong mentoring resources.

Probert: State CPA societies and professional organizations are a valuable resource for CPAs. They provide professional development opportunities and often provide members with access to a database of job opportunities.

Vucinic: There are many networking Web sites that provide opportunities for individuals to establish contacts that may benefit them for years to come.

I would also recommend that individuals take advantage of training budgets and enroll in management leadership skills workshops. These workshops are designed to help improve the soft skills needed to be a successful CPA.

Wright: A well-respected local executive recruiter.

How is globalization affecting CPA hiring trends?

Hisey: CPAs are, and will continue to be, in high demand. As we continue to move toward adopting international accounting standards as common practice, global opportunities will become increasingly available.

Hudson: Certainly, outsourcing opportunities, the interconnectedness of our capital markets and the ability for a new competitor to emerge from out of nowhere underscores the fact that the world is getting much smaller. That's about to change even more with the adoption of the IFRS. The implications to practicing CPAs at all stages of their career, students emerging out of accounting programs over the next five years, and to the CPA exam itself are immense.

Probert: CPA recruiting continues to be a full-throttle agenda item for CPA firms. The demand for CPAs is strong and will continue to be strong in the future.

Those CPA firms that have an international presence have already been affected by global-hiring practices. As John said, these practices will continue to grow as we face the demands of implementing the IFRS.

Vucinic: Globalization, specifically the transition towards IFRS will create a situation where the demand for IFRS skills will undoubtedly exceed the supply. If you have these skills you can expect higher than normal job security and compensation.

Wright: I'm in complete agreement with my fellow panelists. I believe CPAs will need IFRS skills along with strong communication and multilingual skills.

Compared to the last decade, are CPAs more likely or less likely to be job-hopping over the course of their careers? Why?

Hisey: CPAs oftentimes make job changes in their career due to their desire to build out their skill-set. CPAs will continue to take positions at new companies, especially in challenging environments in order to gain the best, most diverse, hands-on experience possible.

Hudson: I think CPAs are going to be much more mobile going forward. This is currently being reflected in traditional benefit systems as they are being retooled to reinforce shorter-term contributions. One example is the disappearance of long-term DC pension plans rewarding long-term employment and the growth of incentive stock options where the incentive is much shorter term.

Probert: Today, most CPA firms have a fairly short and fast path to partnership. That has reduced the incentive to leave firms for faster career advancement in other firms. In addition, work-life balance initiatives have been created by most international, large, national, and regional CPA firms. This has helped retain valuable human capital. However, the demand for CPAs has been so strong that it is quite easy to find a position that better suits your personal and professional needs and also offers strong financial incentive to make a job change.

Vucinic: Basic economic principles rule here. As long as the demand for CPAs exceeds the supply, you can expect similar job-hopping to that of the prior 10 years. I have heard individuals question employee loyalty in the context of job-hopping. My response is always the same, "loyalty is a two-way street; give employees a reason or reasons not to pick up the recruiter's call."

With today's economic environment, the question is how long will demand exceed supply? It's difficult to say, but CPAs are well-positioned even in these difficult times.

Wright: Many hard lessons were learned by workers and employers from the dot-com boom and subsequent job-hopping for equity positions. Most CPAs are looking for stability and long-term growth. I believe we will see a move back to longevity and stability.

READER NOTE: Additional comments from this executive roundtable can be found in the AICPA CPA Insider™ throughout the month of December. Go to www.cpa2biz.com and click on the "Newsletter" tab.

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Who Says Mentors Have to Be Older?

Look to "gentors" to bridge generational differences in your organization.

by Tracy Crevar Warren

It's exciting to see increasing numbers of CPA firms implementing formal mentoring programs to help mold and guide younger professionals. How experienced do you need to be in order to serve as a mentor? Turns out you can mentor at any stage of your career. "Why not a young mentor?" quipped Joe Rotella, Chief Technical Officer of Delphia Consulting.

Are You a "Gentor"?

It's essential to rethink mentoring and the significant impact it can have on your organization. Begin with a new name. "Gentor" refers to a relationship between generations. Gentoring focuses on "sharing" versus a traditional one-way relationship passed down from the senior to the junior. Professionals should be encouraged to have gentors from several different generations for example, a Gen X, a Gen Y and even a young baby boomer.

Breaking the Ice

Here are five key talking points to discuss with your gentor: understand what motivates each other; understand each other's value system; understand each other's communication style; understand each other's approach to work; and

understand what outside of work is important to each other. Tweak your program so it solves the challenges that your firm faces attracting new talent, work-life balance, rewards and compensation, client service, and leadership succession.

After Ice Is Broken

Here are five questions for you to discuss at future sessions. It is important to tailor these questions relative to the issues facing your firm: How do we attract and retain new talent?; How do we make this a better place to work?; How do we make the practice more efficient?; How do we improve our level of client service?; and How do we attract new clients?

Conclusion

Start today. Rethink your mentoring and potential gentoring relationships. You might be surprised at the hidden potential that exists by simply broadening your perspective and finding new ways to relate to those around you.

Tracy Crevar Warren, president and founder of *The Crevar Group*. Warren can be reached at (336) 889-GROW (4769). Views expressed do not necessarily represent those of the AICPA or the *Journal of Accountancy*.



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Uncertain Economy Still Provides Opportunities for CPAs

Job market and practice development prospects remain promising for accountants.

by Sukanya Mitra

Uncertainty seems to be the talk of the town. But you still hope that your niche industry can fight the wrath and fare better. The gloomy headlines from outplacement consulting firm, Challenger Gray & Christmas scream: *"Wall Street Turmoil Alters Plans for Those Starting, Ending Careers. What Will MBAs Do Now?"*

On the flip side, chipper surveys from staffing firm Robert Half International note that to land that essential job you need to add more to your skill palette. "The accelerating pace of globalization and the impending U.S. adoption of International Financial Reporting Standards will continue to drive demand for accounting and finance professionals with international business experience," said Paul McDonald, executive director at Robert Half Management Resources.

To that end, a recent survey of more than 1,400 CFOs nationwide conducted by Robert Half Management Resources found 71% of CFOs agreeing that international experience will be necessary for accounting and finance professionals five years from now. This is up from 56% in 2002.

Latest industry reports reveal that accounting and financial professionals are in a much better position than most because there's always a need for them. "In the short run, business owners typically will seek out more tax, financial and accounting advice in order to most effectively react to the deteriorating economic conditions,"

remarked Blake Christian, Partner with Long Beach, California-based Holthouse Carlin & Van Trigt LLP.

Like many CPAs we reached out to, Christian does not see a "negative impact for the current calendar year." Andy Bose, a Kew Gardens, NY-based sole practitioner concurs: "bleak economy or not, businesses always need accountants."

While all may not be gloomy for practicing accountants, we wondered about soon-to-be graduates. Federal Reserve Bank Chairman Ben Bernanke recently admitted that "jobseekers are experiencing greater difficulties finding work."

Not so. Hiring in accounting and finance is expected to increase in the final months of 2008, according to Robert Half International Financial Hiring Index. Ten percent of surveyed CFOs said they will expand their teams in the fourth quarter.

So whether you are a practitioner or are awaiting graduation, be positive and expect good things even in dire times. As Bose quipped, "Accountants, like doctors and lawyers, may be a reviled breed, but not one business, big or small, can do without them!"

Sukanya Mitra is managing editor of the AICPA Insider™ E-Newsletter Group. Views expressed do not necessarily represent those of the AICPA or the *Journal of Accountancy*.

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States Bite Into Broken Gift Cards



Understanding the impact of state escheat laws

by Charles Owen Kile Jr. and Patricia S. Wall

At the peak of the 2008 holiday shopping season, gift card sales are expected to again have a material impact on the financial reports of many retailers. Gift card “breakage,” or the portion of gift card balances that consumers fail to redeem for merchandise, can boost a retailer’s short-term cash flows. In the long term, gift card breakage can enhance the bottom line of the retailer—or state treasuries—depending on how the retailer’s gift card program is structured and the escheat laws of the states in which it operates.

Escheatment of gift cards creates challenges for both businesses and regulators. Reporting and compliance requirements can be consequential and can place businesses at risk. Stephen Larson, Iowa deputy treasurer and president of the National Association of Unclaimed Property Administrators (NAUPA), warns that there is “a tremendous amount of misinformation out there.” As a result, he says, “many [businesses] fail to adequately understand the reporting obligations that they have under various state provisions.” That’s because requirements are not uniform across states and some potential conflicts remain untested, and thus unresolved. Based upon extrapolations of available information, Larson believes that his state, Iowa, could easily be due as much as 10 times the amount that it actually collects. Estimates such as these, he says, are driving states to “take a fresh look at how to provide clarity to firms with regard to how they can comply with applicable state laws.”

The stated purpose of escheat laws is to unite lost or abandoned property with its rightful owner. But when it comes to unclaimed gift cards, the money paid for the card is seldom united with the gift card owner, given that owner information is rarely recorded, ownership is easily transferable, and it is highly unlikely that a gift card owner who fails to redeem his or her card will, in turn, take the necessary steps to trace funds to a given state and initiate a claim for reimbursement. Instead, most escheated gift card money reverts to the state’s general fund.

According to an NAUPA survey in 2006, states controlled roughly \$33 billion of various unclaimed property, managed more than 117 million accounts, and returned more than \$1.7 billion in property. But obtaining accurate figures on how much of these amounts are attributable to gift card escheatment is difficult because reporting

requirements in most states lump unclaimed gift cards with other categories of abandoned property, such as dividends, payroll checks and utility refunds. However, interviews with the directors of unclaimed property of several states suggest that the amounts escheated from gift cards are substantial. Moreover, while states seemingly are forever adjusting escheat laws, businesses are also adjusting their practices in response to those laws. As a result, companies often find themselves contending with multiple states over the same dollars.

IDENTIFYING WHICH STATE LAWS APPLY

According to Larson, the first, and perhaps most critical, step in compliance with escheat laws is to identify which among the 50 state (and District of Columbia and Virgin Islands) escheat laws apply to a given business. For businesses operating in multiple states, the precedent for determining which state has priority in receiving unclaimed property is established in the rules set forth by the U.S. Supreme Court in *State of Texas v. State of New Jersey* (1965).

In summary, if the holder of unclaimed property can determine the state of the property owner's residence using registration address data, then the holder escheats the property to that state (see Exhibit 1). (With respect to gift cards, the "holder"

Exhibit 1 A Typical Gift Card Transaction

A State where purchase occurred	B State where owner resides	C Holder's state of domicile
A customer purchases a gift card.	Customer gives gift card to a recipient, which results in a transfer of ownership. Recipient is now the owner.	The holder's domicile is considered to be the state of incorporation. The holder may not be the same business that sold the card.

- If the owner has registered the card, the registration information may provide a basis for escheating any remaining unclaimed balance to the state of the owner's residence (State B).
- If no owner information exists or if owner information is challenged, then the holder's state of incorporation (State C) may have a basis for escheating unclaimed balances.
- Alternatively, if the state of the owner's residence (State B) does not escheat unused gift card balances, then the holder's state of incorporation (State C) may have a basis for escheating unclaimed balances.
- If neither State B nor State C escheats unused gift card balances, then State A may have a basis for escheating any unclaimed balances.

would be the business obligated to redeem the gift card). In such cases in which this information is unavailable, the holder would escheat the property to the state of the holder's domicile. Notice that the state of the holder's domicile is considered to be the place of incorporation, and not the state

of its principal place of business.

Although the above consideration summarizes the general precedent to follow, actual applications may vary. For example, if the state that has priority (the state of the owner's residence) exempts businesses from escheating gift cards, then the state of the

EXECUTIVE SUMMARY

■ **Escheatment of gift cards creates challenges** for both businesses and regulators. Reporting and compliance requirements can be consequential and can place businesses at risk because requirements are not uniform across states and some potential conflicts remain untested, and thus, unresolved.

■ **The first step in compliance to escheat laws** is to identify which among the 50 state (and District of Columbia and Virgin Islands) escheat laws apply. For businesses operating in multiple states, the precedent for determining which state has priority in receiving unclaimed property is

established in the rules set forth by the U.S. Supreme Court in *State of Texas v. State of New Jersey* (1965).

■ **Companies are required to file an annual report** stating the amount to be escheated to the applicable state(s). Required reports can be obtained on the NAUPA Web site (www.unclaimed.org).

■ **Many state laws exempt businesses from conducting "due diligence"** with respect to gift cards and other abandoned property below certain amounts. But in response to pressure from state attorneys general, some national retailers have changed

their policies about replacing lost or stolen gift cards.

■ **In some states, such as Washington and California, businesses have successfully negotiated** to be relieved from the obligation of reporting gift cards and gift certificates to the state as unclaimed property. In return, the states forbid businesses from charging service fees, dormancy fees or enforcing expiration dates on gift cards.

■ **Recently, a few gift card issuers have begun to manage breakage** by encouraging customers to register their gift cards on the company's Web site. In return for registering the

gift card, the issuing company promises to replace lost, stolen or destroyed cards, track card balances and provide card verification in the event that customers experience any complications arising from their card transactions.

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business's incorporation has a basis for stepping in as a surrogate to safeguard the owner's assets. Further, the state in which a gift card purchase occurred may lay similar escheat claims in instances where neither of the previously mentioned states have made a claim. Larson warns that "states may push the envelope if the recordkeeping systems are not quite to par, or if the business implies that the laws of that state are not germane to the state's regulatory oversight authority. Consequently, businesses should focus on staying in compliance with those laws that are the most germane."

SUMMARIZING STATE ESCHAT LAWS

Exhibit 2 presents a general summary classification of state escheat laws. Of the 20 jurisdictions classified here, 14 escheat at the rate of the card value, and six escheat at 60% value. The 60% policy is intended to allow businesses to earn a reasonable profit, as though the card had been redeemed, while maintaining the state's mission of preserving unclaimed assets. The dormancy period represents the period of time a gift card can go unused until it escheats to the state. Dormancy periods range from an aggressive two years (Maine) to five years.

Exhibit 3 presents a summary classification of jurisdictions that generally do not escheat. These classifications represent only a general, quick-reference guide because many states make exceptions that create what are, in essence, hybrid laws. Therefore, in determining if and how much to file, businesses must review the many stipulations within each law. Some of the more notable, but not all, exceptions are provided in the table. Three of the more common exceptions arise as follows:

Fees and expiration dates. Although it is becoming less popular to do so, many businesses place expiration dates on their cards or charge fees. Both practices, in effect, erase unused balances in time. Not surprisingly, expiration dates and fees have been a source of conflict and the target of several state legislative initiatives to require clear disclosure of such practices, place limitations upon such practices, or outright ban them. States may also amend escheat laws

to exempt cards provided that they do not expire and/or enforce a fee. These states are included in Exhibit 3. Note Idaho as an exception—the state only exempts cards that have clearly defined expiration dates.

Definition of a gift card/certificate. Several states exempt only specifically defined cards, such as those used by a single or affiliated group of merchants, or exclude certain general usage type cards, such as preloaded bank or generic phone cards. For example, in Colorado gift certificates that are redeemable for cash escheat to the state, whereas those that are redeemable for tangible goods or services do not. Thus, compliance with escheat laws requires careful attention to the definition given by the state

for a gift card.

Amendments to state laws. As legislatures actively amend escheat laws in an attempt to make the law more consumer-friendly, or in reaction to certain business practices, they, in essence, create hybrid systems that exempt cards before, or after, the date that the amendment goes into effect. Exhibit 2 gives the current law as the general case, but businesses must be aware of any previous provisions on the books that still cover older cards.

REPORTING REQUIREMENTS

Each year, companies are required to file a report stating the amount to be escheated to the applicable state(s). Required reports

Exhibit 2 Jurisdictions That Generally Include Gift Cards in Escheat Laws

Jurisdiction	Escheat Rate	Escheat After
Alaska	100%	3 years
Delaware*	100%	5 years
District of Columbia	100%	5 years
Georgia	100%	5 years
Hawaii	100%	5 years
Idaho**	100%	5 years
Iowa	100%	3 years
Louisiana	100%	3 years
Maine	60%	2 years
Michigan	100%	5 years
Mississippi	100%	5 years
Missouri	60%	5 years
Montana	60%	3 years
Nevada	60%	3 years
New Mexico	60%	3 years
New York	100%	5 years
South Dakota	100%	5 years
Texas	100%	3 years
Virgin Islands	100%	5 years
West Virginia	60%	3 years

*Delaware exempts cards with values less than \$5 and holders with aggregate values under \$5,000.

**Idaho exempts cards with expiration dates that are clearly displayed and communicated.

Exhibit 3 States That Generally Exempt Gift Cards From Escheat Laws

Initiation	Special Conditions
Alabama	if for tangible merchandise
Arizona	if after 2005
Arkansas	if not for general usage
California	if no fees or expiration and after 1997
Colorado	if for tangible merchandise
Connecticut	if not a prepaid phone card
Florida	
Illinois	if no fees or expiration and after 2004
Indiana	
Kansas	if not for general usage
Kentucky	
Maryland	
Massachusetts	if no expiration
Minnesota	if not for general usage
Nebraska	if no fees or expiration
New Hampshire	if less than \$100; otherwise 100% after five years
New Jersey	
North Carolina	if no expiration and not for general use
North Dakota	if not for general usage
Ohio	
Oklahoma	if not for general usage
Oregon	if not for general usage
Pennsylvania	if no expiration and not for general use
Rhode Island	
South Carolina	
Tennessee	if no fees or expiration, after 1998 and not for general usage
Utah	if less than \$25; otherwise 100% after five years
Vermont	
Virginia	if for tangible merchandise
Washington	
Wisconsin	
Wyoming	if less than \$100; otherwise 60% after three years

can be obtained online. NAUPA provides a common link to access each state's Web site. A company operating in multiple states is not required to file with every state, although a few states require reports, even when money is not being escheated to that state. Reporting requirements and procedures vary by state, so the filer must pay

careful attention to the details in the report and the laws of a given state. As previously mentioned, receipts from unclaimed gift cards are lumped together with other property, but some states, such as Iowa, are moving toward separate reporting.

Once funds from unclaimed gift cards are escheated to the state, they generally re-

main with the state indefinitely. However, current technology allows businesses to track balances and usage by each individual card (account). If a customer redeems a card whose balance has previously been escheated to the state, the business has a means of tracking that information, and thus has a legitimate basis for reclaiming those funds from the state. For simplicity, reclaimed funds are generally netted out of the amount due with the ensuing filing.

ISSUERS AGREE TO HONOR LOST AND STOLEN GIFT CARDS

Many state laws contain provisions that exempt businesses from conducting "due diligence" with respect to gift cards and other abandoned property below certain amounts (due diligence would require the business to make efforts to locate the owner). However, a recent event highlights that businesses are expected to assume a certain degree of responsibility over gift cards that they sell, even in instances in which the customer does not physically possess the card.

In 2002, the New York Attorney General's Office conducted an investigation against The Home Depot when the retailer refused to honor a customer's misplaced gift card. In response to the investigation, Home Depot agreed to revise its corporate policy to "reissue gift cards for those customers who can provide reasonable evidence" that they purchased a card that was later lost or stolen. Evidence can be a receipt, canceled check, or even a transaction register from the customer's credit card company.

In summary, this event offers one more indication that, in the public's mind, what the business is selling is the obligation to provide a good or service, rather than just the card itself, and that businesses bear a responsibility to view prepaid funds as belonging to the card owners, and not to the holders.

COMPANIES RESPOND

Needless to say, confusion from nonuniform reporting obligations, costs of compliance and the amount of money at stake all combine to motivate firms to devise

ways to attempt to mitigate the effects of escheat laws. One approach that businesses have adopted is to lobby states to relax laws. In some states, such as Washington and California, businesses have successfully negotiated to be relieved from the obligation of reporting gift cards and gift certificates to the state as unclaimed property. In return, legislators require businesses to relinquish their ability to charge service fees, dormancy fees or enforce any expiration dates on gift cards. Such negotiated outcomes have generally been hailed as an example of business and government working together to reach workable solutions for the benefit of the consumer.

Another approach that businesses have adopted is to alter the business's structure so as to also alter who the holder of the unclaimed gift card is and, consequently, the applicable state agency. The general approach is to establish a separate limited liability corporation in a state in which the escheat laws concerning gift cards exist, but are less aggressive. (Recall that if a state does not escheat gift cards, another state can step in and claim escheatment of the property.)

The LLC would primarily exist to manage the gift card program. Diane Green-Kelly, a partner in the Chicago office of Reed Smith, advises clients in escheatment, franchise and antitrust matters. She cautioned that while such a strategy can be advisable, any such arrangement must serve business purposes. In other words, she specifically notes that the subsidiary must have its own management, capital, financial transactions, accounting, fully dedicated board of directors and anything else necessary to create adequate "separation" and "avoid being treated as a sham."

REGISTERING GIFT CARDS ONLINE

Recently, a few gift card issuers, such as Crate & Barrel and Buca di Beppo, have started programs that encourage customers to register their gift cards on the company's Web site. In return for registering the gift card, the issuing company promises to replace lost, stolen or destroyed cards, track card balances and provide card verification in the event that customers experience any

complications arising from their card transactions.

Starbucks even offers incentives such as personalized designer cards, free drinks, refills and drink options and the free use of in-store Wi-Fi service. Customers can also sign up to have cards automatically reload when their balance drops below a specified amount.

Paula Borhauer, who manages the escheat reporting requirements for Starbucks, believes that such initiatives offer several advantages, including the potential to reduce breakage. "From my perspective, I would rather have owners be able to use their card balances," says Borhauer. "Registration offers a way for them to do that, even when cards are misplaced."

However, the owner information provided from registration also likely introduces additional complications to determining escheat obligations. For example, having possession of owner information could imply that the issuing company should establish a basis for escheating to the state of the owner's residence, rather than the company's state of incorporation, since, as previously noted, priority over abandoned property goes to the state in which the owner claims residence.

On the other hand, given the transferability of gift cards (the person who registered the gift card may not necessarily be the current owner), the issuer's state of incorporation could also lay claim to such funds on the basis that the company has no method of proving that the registered individual is, in fact, the current owner. Moreover, Borhauer notes that this issue is further complicated by the fact that some states either don't want or don't accept owner detail because most balances fall under aggregate limits.

Another consideration involves the feature that allows customers to reload balances. State laws generally view the escheat period as stemming from the date that the customer initially purchased the card. However, reloading makes a determination of when a card has been abandoned, and therefore due to be escheated to the state, a lot less straightforward. To date, these issues have yet to be tested, and therefore, re-

main unresolved. Borhauer admits that issues such as these may make reporting even more challenging "considering the volume of card activity and the many considerations that feed into the escheat requirements."

CONCLUSION

The continued growth in the sale of gift cards has made breakage no longer just a byproduct of gift cards, but a potentially material contributor to profit in its own right. Funds from unredeemed cards are at the center of a legal tug of war between states, which have historically taken control of unclaimed assets, and businesses, which face ambiguous reporting and are reluctant to forgo the cash from their gift card transactions. Maybe the fundamental question for society to answer is, "Who better holds the interests of the consumer with regard to prepaid, but unclaimed, gift card balances?" Previous court decisions have viewed the state as custodian of the consumer's general welfare. However, some recent events and trends indicate that businesses also face incentives to devise methods for assuming control over the consumer's interest when the right to receive goods or services goes unclaimed. ♦

AICPA RESOURCES

JofA articles

- "Accounting for Gift Cards," Nov. 07, page 38
- "Unclaimed Property," Feb. 04, page 49

OTHER RESOURCES

Article

"Prepaid Cards and State Unclaimed Property Laws," by Phillip Bohl, Kathryn Bergstrom and Kevin Moran, *Franchise Law Journal*, Summer 2007

Law

State of Texas v. State of New Jersey, 379 U.S. 674 (1965)

Publication

Unclaimed Property: A Reporting Process and Audit Survival Guide, by Tracey L. Reid, John Wiley & Sons, 2008

Web site

National Conference of State Legislatures, www.ncsl.org/programs/banking/GiftCardsandCerts.htm

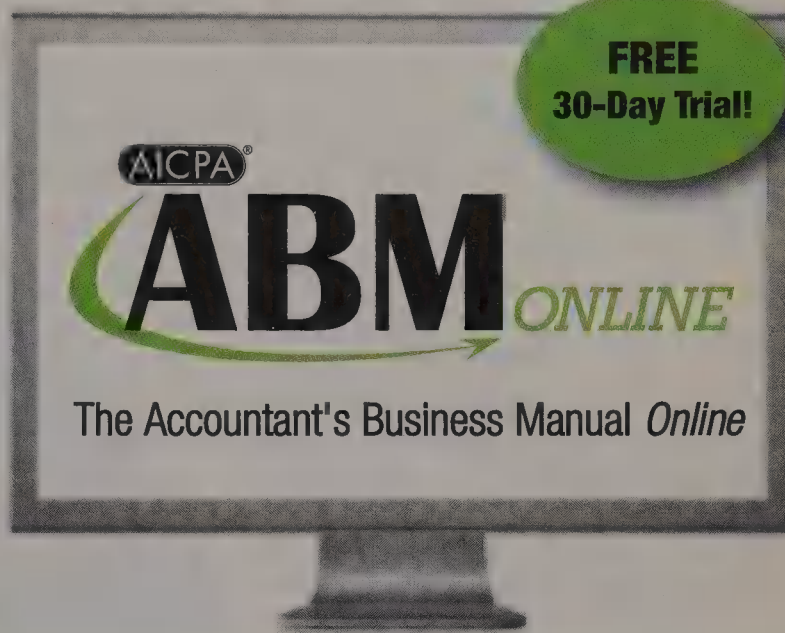
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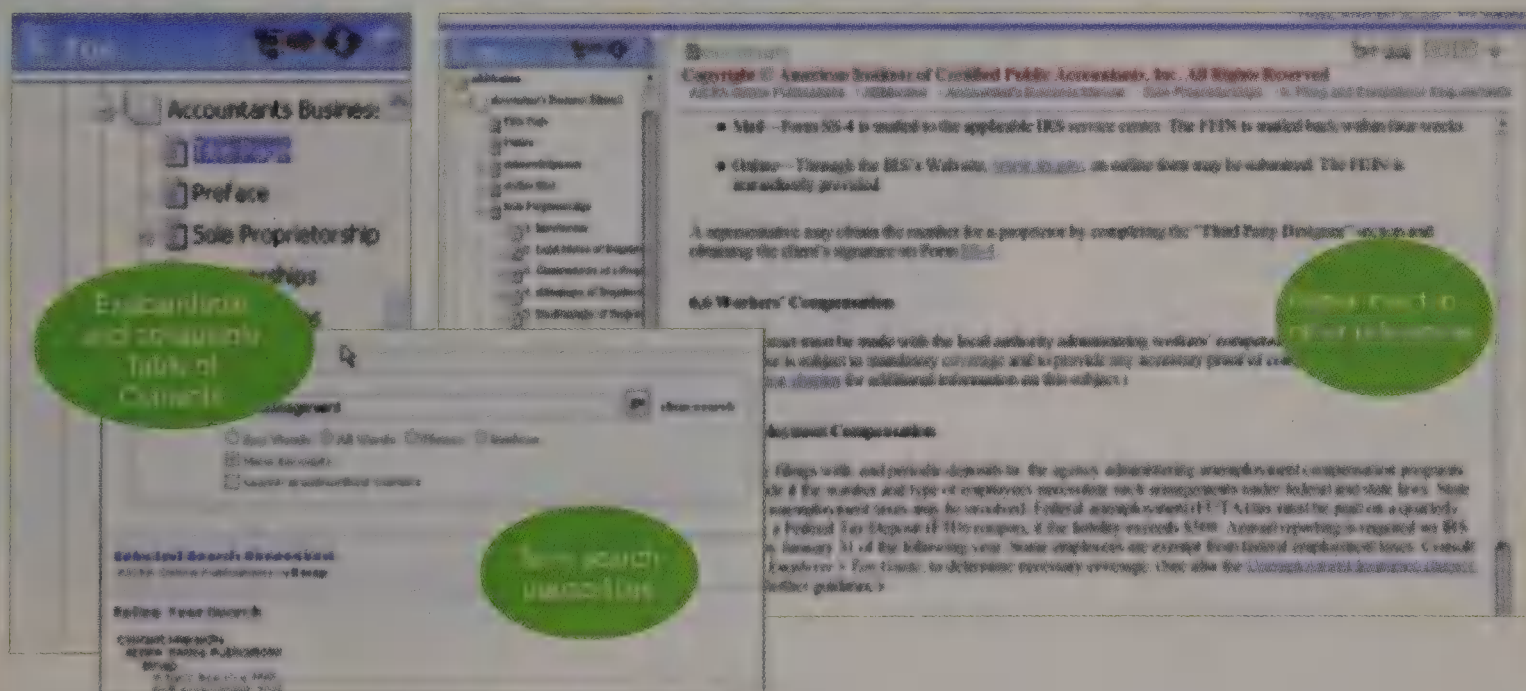
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On the Verge of an Academic Revolution

How IFRS is affecting accounting education

by Kim Nilsen

For those charged with educating the next generation of accountants, the expected shift from U.S. GAAP to IFRS stirs up a host of potentially thorny issues. Professors and college administrators are dealing with questions about the timing of the curriculum expansion and the resources needed to handle IFRS. They are examining how to reconfigure course work to make room for international standards.

The *JofA* hosted a virtual round table, gathering eight academics by conference call to discuss how IFRS is affecting accounting education. The conversation took place Sept. 29, about a month after the SEC voted to expose a proposed road map that could require U.S. public companies to use IFRS by 2014. For more on the round-table participants, see "Round-Table Roll Call" sidebar.

IFRS ON CAMPUS

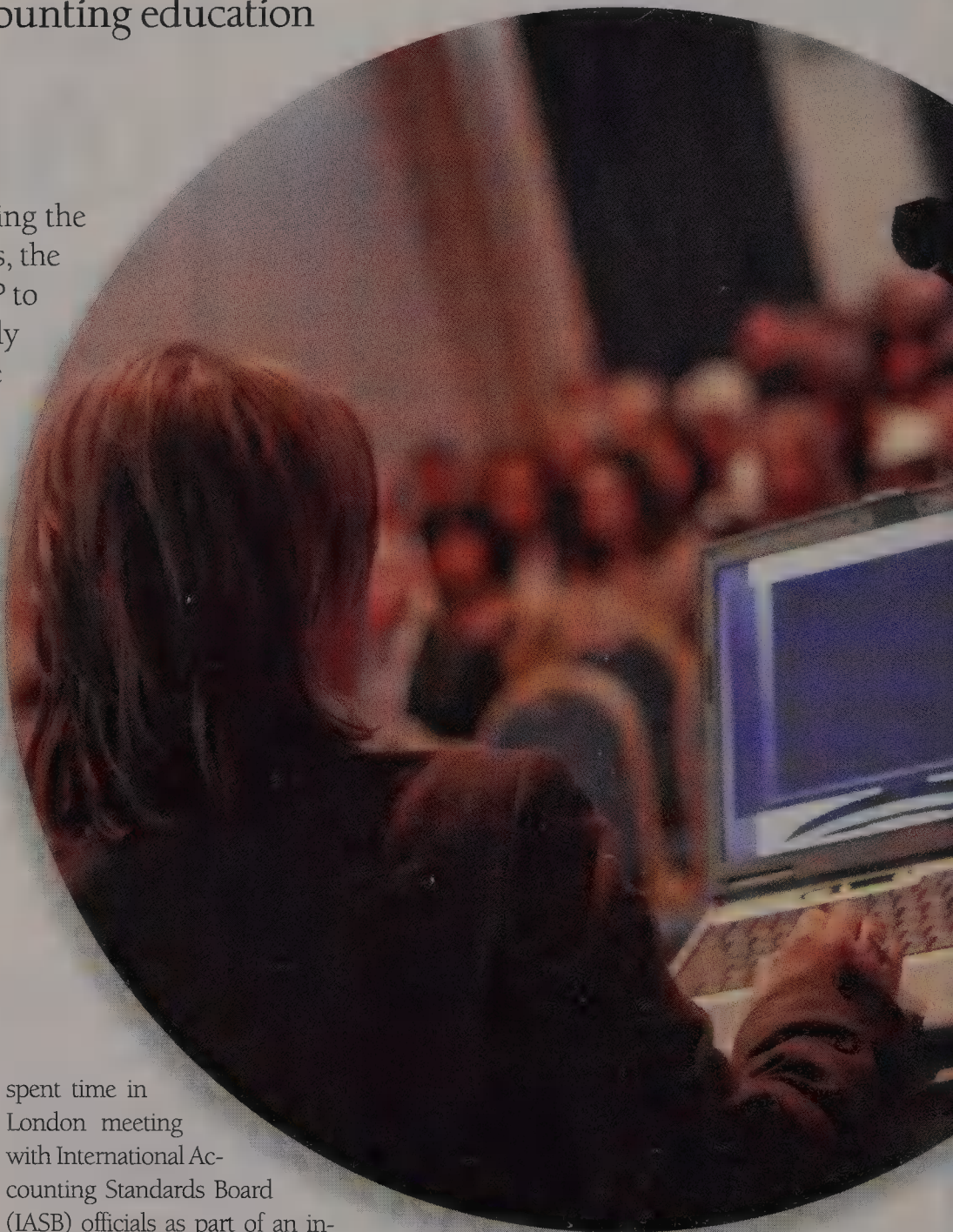
The professors who took part in the call said their accounting programs, to varying degrees, have begun integrating IFRS into course work. At the University of Missouri, for example, students in a graduate accounting policy course are expected to be able to incorporate IFRS into work on various cases. At the University of Dayton, fifth-year students have

spent time in London meeting with International Accounting Standards Board (IASB) officials as part of an international accounting course.

At The University of Alabama, the faculty has agreed to work to integrate IFRS throughout the curriculum, said Mary Stone, director of Alabama's School of Accountancy. Every student taking introductory accounting receives a common

level of exposure to IFRS. That exposure consists of getting an awareness of IFRS, the IASB, the possible transition from U.S. GAAP to IFRS, and certain key differences between U.S. GAAP and IFRS.

However, a recent survey found that



few universities have a strategy in place to incorporate international standards into accounting curricula in 2008–2009. The survey by the American Accounting Association and KPMG LLP, conducted in July and August, showed that just 22% of 535 professors surveyed said they could incorporate IFRS into their courses this year in any significant way. Sixty-two percent said they had not taken any significant steps toward integrating IFRS into course work.

Seventy-nine percent of respondents said the key challenge for them is developing curriculum materials, and another 72% said making room for IFRS in the curriculum is an issue. In terms of plans to prepare faculty to teach IFRS, 49% said the burden is on the shoulders of the individual faculty member, the survey found. Only 16% said their schools would provide funding to attend training sessions and/or acquire study materials.

"I think that's something that's changing very quickly," said Gary Sundem of the University of Washington. "The administrators are getting pressure from the firms, from the (AICPA), and I would guess, even now, things have changed since that survey."

Wayne Landsman of the University of North Carolina at Chapel Hill said, in the short term, deans are focusing on whether teaching U.S. GAAP as well as IFRS might require more staff or man-hours.

RESHAPING THE CURRICULUM

The JofA asked the professors how adding IFRS course work on top of U.S. GAAP will affect the teaching of other topics such as management accounting. Mary Barth, a Stanford University professor and a member of the IASB, argued that IFRS can't simply be layered on top of the existing curriculum.

"And in some sense there's no reason to. You know, U.S. GAAP and IFRS are

Round-Table Roll Call

The participants in the round table on IFRS and accounting education:

■ **Mary E. Barth**, CPA, Ph.D., MBA, is the Joan E. Horngren professor of accounting and senior associate dean for academic affairs at the Stanford University Graduate School of Business. She has been a member of the IASB since 2001.

■ **Wayne R. Landsman**, Ph.D., MBA, is the KPMG professor of accounting and the associate dean of the Ph.D. program at the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill. He is a former FASAC member.

■ **Belverd "Bel" Needles Jr.**, CPA, Ph.D., MBA, is Ernst & Young Distinguished Professor of Accounting in the School of Accountancy and Management Information Systems at DePaul University. He is past president of the International Association for Accounting Education and Research and of the Federation of Schools of Accounting. He is vice president-elect, education, for the American Accounting Association.

■ **Loren A. Nikolai**, CPA, Ph.D., MBA, is the Ernst & Young Distinguished Professor at the Robert J. Trulaske Sr. College of Business at the University of Missouri. He has written several textbooks including *Intermediate Accounting*. He is past director of education for the AAA and past president of the Federation of Schools of Accountancy.

■ **Frank K. Ross**, CPA, is a visiting professor of accounting at Howard University's School of Business and is director of the school's Center for Accounting Education. Ross held several positions at KPMG LLP, where he retired as mid-Atlantic area managing partner.

■ **Mary S. Stone**, CPA, Ph.D., is the Hugh Culverhouse Chair and director of the School of Accountancy at The University of Alabama. She is chair of the AICPA's Pre-Certification Education Executive Committee. She is a past president of the AAA.

■ **Donna L. Street**, CPA, Ph.D., is a professor and the Al and Marcie Mahrt Chair in Accounting at the University of Dayton School of Business Administration. She is president of the International Association for Accounting Education and Research and serves on the International Accounting Standards Committee Foundation's Education Advisory Group.

■ **Gary Sundem**, Ph.D., MBA, is professor emeritus of accounting at the University of Washington. He is co-author of such textbooks as *Introduction to Financial Accounting* and *Introduction to Management Accounting*.

very close in concept," she said. "It would be almost silly to have two separate courses at this point, both starting at the same place and just ending up with slightly different details."

Alabama's Stone said the key to making all of the pieces fit within existing resources is making sure that students have a strong foundation in finance and economics.

The University of Missouri is considering combining fair value accounting and IFRS in a conceptual-based course "because of the need for students to develop more expertise in how to make good judgments regardless of the topical area," said the university's Loren Nikolai.

"I suspect that we will have a course

in valuation, related to fair value accounting, before all this is over," said Bel Needles of DePaul University. "Forensic accounting is another area that's becoming important. Ethics/professional responsibility is another area. All of these are important areas, and it's hard to say, 'OK, we're going to cut that one back and do something else here.' So, I think there's going to be a period of transition over the next several years in which we'll see a lot of pressure to increase the amount of courses for accountants."

With the future of who sets standards for private company reporting still a question mark, one lingering issue is how much GAAP should remain in the

A Bilingual Future

As college accounting departments work to weave IFRS into an already busy curriculum, a separate but related conversation is going on among AICPA members about an expectation that U.S. GAAP will continue to be relevant for some time. GAAP's lingering presence makes it likely that entry-level CPAs will need to be "bilingual" or conversant in both sets of accounting standards.

Some CPAs are already using both U.S. GAAP and IFRS, and those who work for certain multinational companies have had to be bilingual with respect to accounting standards for several years. A CPA who works in the U.S. for a company that is owned by a foreign parent typically prepares IFRS-based financial statements for its parent and, in some cases, U.S. GAAP-based financial statements for use in the United States.

The need to be "bilingual" is not restricted to domestic CPAs. International financial professionals may need to be able to work with U.S. GAAP and IFRS. About 10% of the candidates who take the Uniform CPA Examination come from outside the United States, an indicator of the continuing value of competency in U.S. GAAP.

Even if U.S. GAAP remains the primary basis of accounting for private entities in the United States, it will still be important for U.S. practitioners to be fluent in both U.S. GAAP and IFRS. CPAs who work for or audit private companies that don't adopt IFRS are likely to find themselves comparing their companies' financial results to those of competitors who have adopted the international standards. Understanding IFRS will also be important in evaluating investment portfolios that include foreign companies whose financial statements are based on IFRS.

As part of its practice analysis project for updating the content of the CPA exam, the AICPA's Examinations Team has been evaluating the impact of IFRS on the tasks performed by entry-level CPAs. The "bilingual" climate will require careful planning to balance appropriate proportions of IFRS and U.S. GAAP topics in both the CPA exam and academic curriculum. Those proportions will likely change over time as the profession's use of IFRS continues to grow.

—by Kim Nilsen

U.S. accounting curriculum. The SEC's IFRS road map applies only to public companies. The IASB and, in the U.S., the AICPA and the Private Company Financial Reporting Committee, are among the groups mulling possible courses for private companies.

"Could you not imagine that U.S. GAAP or British GAAP would be a sort of specialty course, an elective course, for students that want to go to work in the private sector or the banking sector, or whatever the most appropriate one is for them?" Landsman asked.

"I don't know whether that's going to

happen, but that certainly would be a plausible outcome," Barth said.

For now, students' awareness of IFRS is generally low. "For the most part, this (awareness) is being driven not by students, but more by faculty and, of course, the firms," Landsman said. But round-table participants expect to see that dynamic change quickly.

"I think when the switch gets flipped, it's going to be very fast," Barth added. "Once word gets out, there is going to be a tremendous demand from the students. For the students it opens up a lot of opportunity, because they realize that if they

know about international standards, they can go anywhere in the world."

With most major firms now weaving IFRS into their internship programs, interns are returning to campus with some familiarity with international standards and some questions for faculty, says Frank Ross of Howard University.

The Uniform CPA Examination is also a major driver in the reworking of accounting curriculum. "The minute you start asking questions about it on the CPA exam, then that becomes the impetus for faculty to teach it and for students to learn it," Barth said.

That date may be sooner than many professors expect, said Donna Street, a University of Dayton professor who is serving on a committee advising the AICPA's Examinations Team on how and when to incorporate IFRS into the CPA exam. "I think educators need to be very, very aware that the AICPA is already working on how the exam is going to be modified. And when you're teaching sophomores or juniors and the exam may be changed by the time they're going to take it, we've got to get this into the classroom."

RIPPLES FROM THE FINANCIAL MELTDOWN

Conversation during the round table, which was held as Congress was working to pass the \$700 billion financial rescue package, inevitably turned to the economic crisis. Missouri's Nikolai asked whether the tumult would fuel concern about IFRS's reliance on judgment over rules.

From a practical standpoint, the professors wondered if the economic crisis might slow the U.S. transition to IFRS. "I think that there's going to be a feeling that we shouldn't call on (managers) to do anything except run their businesses and try to get out of the holes that they're in," Stone said. "I guess that the implication for us as educators is to somehow keep the pressure on other professors to continue to work on integrating IFRS, because even though there's a slowdown, I think with a global economy like we have, it's inevitable that eventually we will be moving to IFRS."

To Land a Job, Some IFRS Required

Several factors are likely to influence how and when universities fully incorporate IFRS into the accounting curriculum. The SEC road map and the introduction of IFRS material on the CPA exam are expected to drive the transition.

PricewaterhouseCoopers has weighed in with a driver of its own—a recruiting plan that could fuel interest in IFRS among students and quicken the pace of change on college campuses. PwC, which employs more than 1,500 interns and hires more than 3,000 employees from campuses each year, announced that starting in fall 2009 it will weigh IFRS awareness when evaluating students interviewing for full-time jobs or internships.

The firm will expect sophomores who have taken at least one accounting course to be able to explain the general uses of U.S. GAAP and IFRS and to recognize the importance of IFRS in the future.

For juniors, seniors and graduate students interviewing for internships or full-time positions, the expectations will be higher. PwC also wants those students to be able to articulate the sources of U.S. GAAP and IFRS; describe an example of IFRS financial statements; and identify an example of a difference between U.S. GAAP and IFRS. Those candidates would also be expected to explain the current status and likely timetable for adoption of IFRS.

Jean Wyer, a partner who heads PwC's college and university relations, says the firm will likely raise the bar on IFRS awareness for fall 2010 recruiting.

Faculty members were the primary target audience for the July release of the new requirements. "We understand faculty need lots of warning," Wyer said. In the spring, the firm will begin a push to raise awareness of the requirements among students.

At the PwC University for Faculty in early July, the firm rolled out a suite of interactive tools, such as IFRS financial statements, and videos and software. The tools are designed to, among other things, allow students at colleges and universities that do not yet offer instruction on IFRS to fulfill PwC's new requirement.

—by Kim Nilsen

IMPACT ON THE PROFESSOR PIPELINE?

The round-table participants said they've picked up on a fear factor among professors about the sheer magnitude of taking on IFRS in the classroom. Getting up to speed on international standards and adapting course work to incorporate the international rules may be too much for some professors, said Howard University's Ross. "Some of them may just opt to retire early, creating more of a shortfall. I think the requirement of having to learn principles-based accounting probably will make the shortage a little bit more serious of a crisis," he said.

At the same time, an undercurrent of excitement is running through some lecture halls, where professors may find mov-

ing away from teaching rules-based GAAP liberating. "I think that for a lot of educators, the principles-based framework approach to teaching is really more comfortable. And the reliance on underlying economic constructs is more comfortable and more consistent" than some GAAP standards, Stone said. "I think in some ways this is actually going to be easier for professors, especially once they feel like they have materials that they can use."

Ross said that an IFRS-based approach to teaching will encourage students to think on their feet and search for the facts. "I think that will make it more exciting." ♦

Kim Nilsen is the editorial director of the JofA. Her e-mail address is knilsen@aicpa.org.

AICPA Publications

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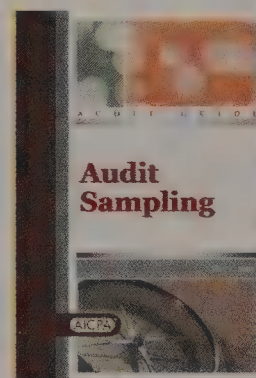
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Highlights of Accounting Systems Research

Keep up with the latest findings on the impacts of IT investments.

by Cynthia Bolt-Lee and Janette Moody

This article is the fourth in a series reviewing research relevant to practicing accountants. Previous articles covered auditing, management accounting and tax. Recent, top-ranked journals that cover accounting and information technology systems were examined to determine results containing practical implications.

HOW IT OUTSOURCING IMPACTS STOCK PRICES

When a firm publicly announces the use of outsourcing in the area of information technology (IT), the firm's short-term stock price is affected. Investors respond depending upon the transactional risk of the outsourcing and the vendor chosen to perform the work. Transactional risk in IT relates to the risk associated with the loss of control over the vendor performing the outsourcing, the specific software being outsourced and the outsourcing agency itself.

Authors Wonseok Oh, Michael Gallivan and Joung Kim examined changes in the stock market price that occurred five days before and five days after a firm announced a new outsourcing of its IT. The research was designed to determine how

investors react to a variety of IT outsourcing scenarios. Their work studied investor behavior under several categories: the extent of outsourcing, challenges with outsourcing in monitoring performance, use of customized or vendor software, vendor competence, and the cultural differences between the firm and vendor.

Their study determined that investors associate greater risk with large outsourcing contracts as well as with small vendors receiving large contracts. Likewise, if customized software is outsourced, investors are more skeptical. Their findings also suggest that cultural differences between the company and the outsourcing agency negatively affect the investor's decision. The reverse in each scenario also holds true, with investors reacting positively to the percep-

tion of low transaction risk.

Generally, the findings conclude that stock investors recognize the overall risk of specific types of IT outsourcing. The article, "The Market's Perception of the Transactional Risks of Information Technology Outsourcing Announcements," was published in the Spring 2006 issue of the *Journal of Management Information Systems*.

ALIGNING STRATEGY WITH IT

In a survey of 274 chief information officers (CIOs), researchers Grover Kearns and Rajiv Sabherwal examined the importance of coordinating business strategy with investments in IT to avoid costly mistakes. Their results showed the importance of centralized decision making and an organizational focus on knowledge management. The



study reveals the value of top management's coordination with IT in both planning and implementation of projects.

The authors' research, appearing in an article in the *Journal of Management Information Systems* titled "Strategic Alignment Between Business and Information Technology: A Knowledge-Based View of Behaviors, Outcome, and Consequences" (Winter 2006/2007) suggests several implications for practice. Their work stresses the importance of top management's knowledge of current and potential IT projects. This includes frequent meetings with the CIO, IT management, and non-IT management to ensure an information exchange between all parties involved relevant to technological advances, competition and business operations. Addition-

ally, the study shows that collaboration between these groups during implementation addresses potential problems more efficiently.

USING ERP TO ADD VALUE

IT investments continue to consume a large part of an organization's capital budget, and therefore call for a closer look at the best way to successfully implement and enhance their value to the organization. The research studies discussed below examine these important questions.

One major IT investment is the implementation of an enterprise resource planning system (ERP) that has the potential to deliver major benefits to the firm. The goal of these enterprisewide systems is to eliminate the operational silos that exist

when systems of various functional areas are not well-integrated. Systems that are not integrated fail to provide centralized data sharing and real-time information for decision makers. A successful ERP system, therefore, can prepare the way for future IT-dependent initiatives such as tighter supply chain integration, improved e-commerce capabilities and enhanced organizational learning.

Given the potential positive benefits of an ERP implementation, it is expected that investors will react to a firm's announcement and signal their approval or disapproval. Researchers C. Ranganathan and Carol Brown examined how investors react in their study "ERP Investments and the Market Value of Firms: Toward an Understanding of Influential ERP Project Variables" (*Information* ➤

Systems Research, June 2006).

After reviewing the market impact of ERP announcements by 116 firms in diverse industries, they found that an announcement of an ERP project implementing two or more software modules that affect the value-chain (material man-

unique decision styles of Asian firms.

To make a Western system useful for an Asian business, modification is required. This is best accomplished through the use of the local business knowledge that must be considered along with the technical knowledge of the consultants.

"Data perturbation" is commonly used to add random "noise" to identifiers before analysis so that the original information cannot be uniquely identified.

agement, operations, sales, etc.) got a bump in market value of 2.86%. In addition, announcements for projects with larger physical scope, covering multiple sites and divisions, had a market value increase of 2.34%. Conversely, the ERP announcements of projects with limited functional and physical scope resulted in slight negative returns, signaling limited expectations that the firm's benefits would offset the ERP investment costs. It is interesting to note that the ERP vendor's reputation and status did not significantly affect investor reactions.

CULTURAL IMPLICATIONS OF ERP

Organizations that manage or interact with systems outside of the United States, particularly in Asian countries, should be aware of the impact of culture on the success of an ERP implementation. Researchers Eric Wang, Gary Klein and James Jiang found that the ERP vendor's country of origin is significant to the project's success because a large part of an ERP system's value lies in its ability to standardize business processes based on a belief in how things "ought to be done" that differs between Western and Eastern cultures ("ERP Misfit: Country of Origin and Organizational Factors," *Journal of Management Information Systems*, Summer 2006).

Such "belief-based" formalized procedures are an integral part of ERP packages from major global vendors in Europe and the United States, and do not support the more flexible operational practices and

ENSURING PRIVACY WHILE DATA MINING

One business asset that continues to provide value to an organization is the data it has collected. Data mining tools have been effectively used in fraud detection, risk assessment of loan applicants, medical diagnostics and other decision processes. Data mining seeks to discover hidden relationships between factors (attributes) associated with records in the database. With technology supporting faster collection and cheaper data storage, the next concern is the privacy of confidential information.

Organizations often think that if they remove unique information such as Social Security number, name or address, they will keep the data confidential even if it is analyzed by data mining tools. However, once the data are grouped into categories, such as age, gender, location, occupation, marital status or medical treatment, it is possible that a record will be unique and thus recognizable even without a unique identifier. The larger the number of categories, the greater the likelihood of a recognizable record.

To combat this problem, "data perturbation" is commonly used to add random "noise" to identifiers before analysis so that the original information cannot be uniquely identified. Xiao-Bai Li and Sumit Sarkar ("Privacy Protection in Data Mining: A Perturbation Approach for Categorical Data," *Information Systems Research*, September 2006) have created a data perturbation method that will provide

privacy even when working with data grouped into multiple categories. Businesses and medical institutions often collect data from customers and patients in prespecified categories such as age, gender, income brackets and ZIP code. The authors recommend that an organization's IT department use this method to ensure confidentiality of information before data analysis. ♦

Cynthia Bolt-Lee, CPA, M. Taxation, is an associate professor at The Citadel School of Business Administration in Charleston, S.C., and **Janette Moody, CPA, Ph.D.**, is a professor at The Citadel School of Business Administration. Their e-mail addresses, respectively, are boltc@citadel.edu and janette.moody@citadel.edu.

AICPA RESOURCES

JofA articles

Previous articles in series

- "A Showcase of Tax Research," Oct. 08, page 48
- "Management Accounting Research for the C-Suite," Nov. 07, page 50
- "Mining Audit Research," April 07, page 68

Other related articles

- "Managing Multiple Identities," Sept. 08, page 38
- "Join the Hunt: Customize Join Properties for Better Data Analysis," Sept. 08, page 46
- "Test Your Information Security IQ," July 08, page 50

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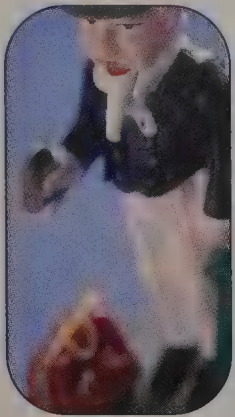
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TAX PRACTICE CORNER

Withholding From Foreign Payments: IRM Section Offers Insight

CPAs with clients whose responsibilities include withholding and remitting taxes on payments to foreign individuals and entities can help those clients understand guidelines and institute sound practices. Often, these “withholding agents” are financial institutions, but they can include any individual, business or other entity paying U.S.-source income to a foreign individual or entity in exchange for services.

The stakes are potentially high: The withholding agent can be liable to the IRS for the amount of tax required to be withheld, as well as for interest and penalties. A new Internal Revenue Manual section highlights this area as one of heightened scrutiny by the Service. Its provisions can also be useful to CPAs in advising their clients, since they offer a glimpse into how IRS examiners will audit these withholding obligations.

GENERAL REPORTING RULES

U.S. taxpayers must file information forms reporting certain payments to foreign corporations, foreign individuals, partnerships, and certain fiduciaries, trusts and estates. See IRC §§ 1441 and 1442 and Treas. Reg. §§ 1.1441-1 through -9. Generally, every U.S. person who makes a fixed or determinable payment of annual or periodic income (FDAP payment) from U.S. sources must withhold tax—generally 30%—and remit it to the IRS. A “person” in this sense includes U.S. citizens and residents, domestic partnerships and corporations, and certain estates and trusts. They must also file Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and information return Form 1042-S, *Foreign Person’s U.S. Source Income Subject to Withholding*.

The 30% withholding rate can be reduced by various exceptions provided in the statute or by a reduced rate of tax under a tax treaty (Treas. Reg. § 1.1441-6). For certain types of payments, treaty-reduced withholding rates are available, but only if the beneficial owner of the payment provides the withholding agent with a withholding certificate that includes a taxpayer identification number. This requirement should be carefully complied with by the withholding agent, given the potential liability by the agent for taxes, penalties and interest.

NEW IRM SECTION

In July, the IRS issued Internal Revenue Manual section 4.10.21, “U.S. Withholding Agent Examinations—Form 1042,” that instructs IRS examiners to more closely examine and enforce the statutory requirements for withholding and the related compliance reporting of FDAPs to foreign persons.

The IRM notes that withholding agent audits are likely to be of U.S. financial institutions required to report and withhold tax on behalf of nonresident aliens (NRAs) in connection with the institutions’ custodial or brokerage activities. But audits could also be of nonfinancial entities paying foreign persons for services, it states.

INSTRUCTIONS TO WITHHOLDING AGENT EXAMINERS

Withholding agent examiners should consider Form 1099 reporting and backup withholding as part of an integrated audit, the new IRM section states. In addition, when auditing Form 1042, the examiner is supposed to ascertain the statute of limitations on the audit years for both Form 1042 and Form 945, *Annual Return of Withheld Federal Income Tax*. The IRM instructs the examiner to obtain and have executed, if applicable, Form 872, *Consent to Extend the Time to Assess Tax*, and Form SS-10, *Consent to Extend the Time to Assess Employment Taxes*, to protect the statute of limitations on such forms.

RELIANCE ON WITHHOLDING CERTIFICATE

The IRM provides guidance to withholding examiners with respect to reliance on a withholding certificate (Form W-8) that is part of the review process of Form 1042 and Form 1042-S. A U.S. withholding agent can generally rely on a properly completed withholding certificate to establish foreign status or claim treaty benefits. The withholding certificate must be completed with respect to any item that is relevant to a claim for treaty benefits.

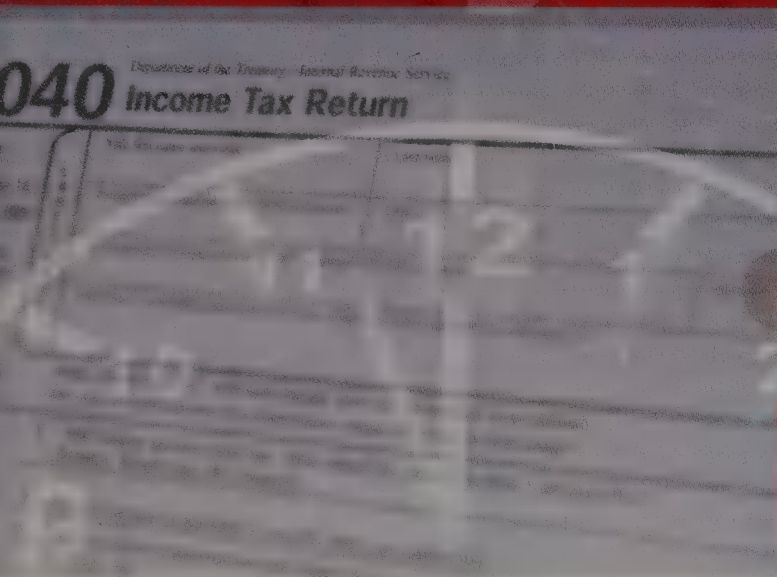
VARIOUS PROVISIONS

The IRM instructs the withholding agent to request for each account under review withholding certificates, other evidence for offshore accounts, and account information needed to administer and open the account (that is, addresses, account holder’s status and other account instructions). The examiner also is instructed to ask for an explanation of the withholding and reporting procedures for real estate investment trust (REIT) distributions, original issue discount (OID) transactions, and security lending transactions.

By **Philip T. Pasmanik**, CPA, MST, a senior manager at Rothstein, Kass & Co. PC in Roseland, N.J. He is a member of the AICPA International Tax Technical Resource Panel and chair of its Forms 1120F/5472/1042 Task Force. His e-mail address is ppasmanik@rkco.com.

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TAX MATTERS

PRACTITIONER PRIVILEGE, TAX SHELTERS

"SIGNIFICANT PURPOSE" OF TAX AVOIDANCE TRUMPS DOCUMENT PRIVILEGE

The U.S. District Court for the Northern District of Illinois required Valero Energy Corp. to produce documents sought by the IRS, saying they were not protected by the tax practitioner privilege of IRC § 7525 because they concerned a tax shelter. In so holding, the court adopted a more expansive view of what constitutes "promotion" of a tax shelter than the one that figured in the *U.S. v. Textron* ruling now pending appeal in the First Circuit.

At issue in *Valero* were written communications between the oil refiner and its then-tax adviser, Arthur Andersen, in connection with Valero's merger with Ultramar Diamond Shamrock Corp., a Canadian company. A series of transactions between Valero and its Canadian subsidiaries resulted in large foreign currency losses (claimed under sections 987 and 988) for Valero that produced \$46 million in U.S. tax savings. The government claims in ongoing litigation that the losses were due to two circular cash flows undertaken expressly to create the tax loss.

After the court ruled in August 2007 that the work product privilege applied to some sought documents but not others, Valero supplied additional documents, some of them redacted, but withheld others, claiming they were confidential communications protected by the practitioner privilege (section 7525(a)(3)). The government moved to produce all the documents without redaction.

The court noted that under section 7525(b), the privilege does not apply to written communication "in connection with the promotion of the direct or indirect participation" of a corporation in a tax shelter as defined in section 6662(d)(2)(C)(ii). Valero alleges that the transaction in ques-

tion was not a tax shelter, that it reflected "economic reality and other business purposes." The court, however, held that the government need not establish that the transaction lacked economic reality or was driven primarily by tax avoidance concerns. Instead, under section 6662(d)(2)(C), avoidance or evasion of federal income tax need be only a *significant purpose* of the plan or arrangement. Since there was evidence, as the government claimed, of the losses being artificial circular transactions (some of which had a bank account open for only one day), the court held that tax avoidance was a significant purpose of the transactions.

Valero further argued that the word "promotion" refers only to the peddling of prepackaged tax shelters, as alluded to in *Textron* (100 AFTR2d 2007-5848, "Tax Matters: Work Product Stands Up to IRS Summons," *JofA*, Nov. 07, page 80). The *Valero* court instead interpreted the word "promotion" more broadly, stating that it also applies to a person who assists in organizing a tax shelter. By advising Valero on a "step plan" that included the proposed Canadian refinancing transactions—a significant purpose of which was tax avoidance—the communications between Arthur Andersen and Valero were in promotion of a tax shelter, the court said.

■ *Valero Energy Corp. v. U.S.*, 102 AFTR2d 2008-5916

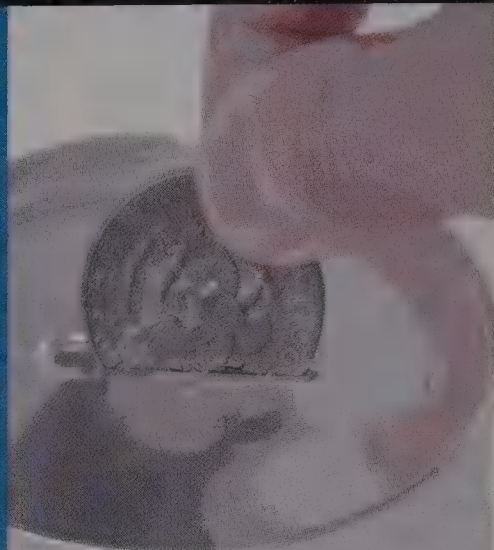
By **Brian Elzweig**, J.D., LL.M., assistant professor of business law, Texas A&M University—Corpus Christi.

CONSTRUCTIVE RECEIPT OF INCOME

TWIN OUTCOMES FROM CAP GEMINI DEAL

In two more of at least four similar cases, former Ernst & Young consulting partners were denied refunds of tax they paid on stock received from a merger with Cap

IRA Charitable Rollovers Keep On Rolling



The Emergency Economic Stabilization Act of 2008 extended for 2008 and 2009 tax-free qualified charitable distributions from individual retirement accounts (IRC § 408(d)(8)). Charities reported to the National Committee on Planned Giving that they received \$140 million under the provision between August 2006 and its original expiration at the end of 2007.

Source: National Committee on Planned Giving, <http://tinyurl.com/4g63ua>.

Gemini that lost most of its value while in restricted accounts.

In 2000, Cap Gemini agreed to purchase E&Y's consulting practice for stock. The tax, audit and consulting partners received stock, and the consulting partners agreed to work for Cap Gemini. The purchase contract specifically classified the transaction as a taxable purchase.

The contract permitted the partners to sell 25% of their shares to pay their tax liability from the sale. The remaining 75% was put into a restricted account and could not be sold for more than four years. If partners left Cap Gemini or were fired for specified reasons, they would forfeit stock in the restricted account

under a liquidated damages schedule. The sales contract provided that the fair market value of the restricted stock was 95% of its closing price on the date of the transaction (May 23, 2000), or \$148.53 per share.

One of the partners, Robert Bergbauer, received 10,740 shares of Cap Gemini. On his 2000 tax return, Bergbauer reported his entire gross proceeds from the sale of \$1,613,379 and a total tax liability of \$676,493.

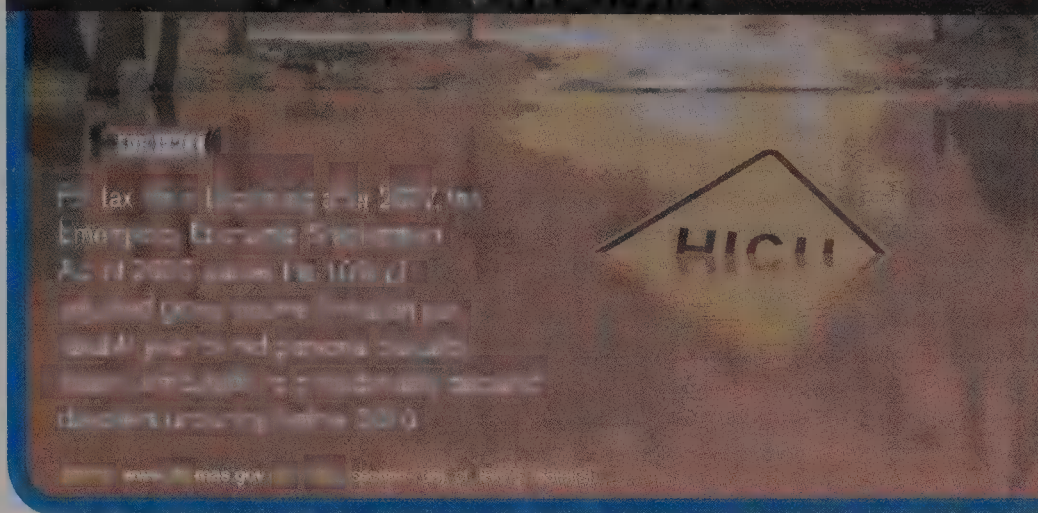
Throughout the negotiations, E&Y distributed the proposed documents to its partners. It held a meeting to discuss the transaction and to allow the partners to ask questions. The reason the transaction was structured as a currently taxable sale was to prevent the IRS from reclassifying some of the restricted stock as compensation for services and to ensure favorable tax treatment for the consulting partners on its future sale. Included in the transaction documents signed by Bergbauer and the other partners was a form that stated that the partners would report the transaction as a taxable sale at the stated value.

By two years after the sale, the value of the restricted stock had fallen to \$16 per share. Bergbauer filed an amended return claiming that the sale was not fully taxable at closing and obtained a refund of \$276,510, including interest. The IRS sued in 2005 to recover it. The case was stayed for more than a year while other cases of the estimated more than 200 similarly situated taxpayers were resolved.

Bergbauer argued that as a cash method taxpayer, under section 451, he did not have to report the restricted stock until received.

The U.S. District Court for Maryland, where the case was tried, pointed out that two other district courts had ruled previously on similar arguments brought by other former E&Y partners. In *U.S. v. Culp* (99 AFTR2d 2007-618), a district court in Tennessee found the contract documents unambiguous and applied the *Danielson* rule to determine if a taxpayer could report the transaction differently than provided in the documents. Under *Danielson* (19 AFTR2d 1356 (3d Cir. 1967)), the taxation may vary from the documents

Limit Waived for "Net Disaster Losses"



only if there was "mistake, undue influence, fraud or duress." Given the steps E&Y took to ensure all the partners understood the contract, the *Culp* court ruled for the IRS. In *U.S. v. Fletcher* (101 AFTR2d 2008-588), a district court in Illinois also applied the "strong proof" doctrine. Under it, the taxpayer must have strong proof that the partners intended a transaction different from the one in the contract. The Illinois court also considered Treas. Reg. § 1.451-2, which provides that constructive receipt of income does not occur when a taxpayer's control of its receipt is subject to substantial limitations or restrictions. The provision does not bar enforcement of the contract as contrary to public policy, the court said in also ruling for the IRS.

In *Bergbauer*, the court did not use either doctrine. Instead, it followed the Fourth Circuit Court of Appeals' approach (stated in *Wangler Apparel Corp. v. U.S.*, 78 AFTR2d 96-5674), first examining the tax consequences contemplated by the parties and then the economic substance of the agreement. Based on the negotiations, meetings and signed documents, it was clear that the parties intended a fully taxable transaction, the court said. To test for economic substance, the court examined whether there was independent value grounded in economic reality behind the contract. The restrictions were intended to protect Cap Gemini from immediate sale of the stock, which would have harmed the stock's value. The restrictions also kept the

partners working for Cap Gemini and provided them with anticipated upward growth of the stock value. For the third time, a court ruled for the IRS.

After the *Bergbauer* decision, the U.S. District Court for New Hampshire ruled similarly in a case brought by another partner, Nancy R. Berry. This court also used the strong proof rule. It rejected Berry's argument that because she was not a party to the negotiations she had no choice in the transaction. The court also rejected the argument that the true value of the restricted stock and not the agreed value should have been used. The actual value was immaterial, according to the court, since the parties agreed to use the 95% valuation.

Normally, a cash method taxpayer does not have to report an item of income if it is restricted or forfeitable. However, taxpayers can agree to report it in spite of these limitations. If it turns out that the restrictions cause an economic loss, it is highly unlikely that the courts will allow taxpayers to revise how they reported the transaction originally—all the more so if the Fourth Circuit upholds *Bergbauer* (notice of appeal has been given).

■ *U.S. v. Robert L. Bergbauer*, 102 AFTR2d 2008-5932

■ *U.S. v. Berry*, 102 AFTR2d 2008-5365

By **Edward J. Schnee**, CPA, Ph.D., Hugh Culverhouse Professor of Accounting and director, MTA program, Culverhouse School of Accountancy, University of Alabama, Tuscaloosa.

INCOME AND DEDUCTIONS

LEASE BUYOUT PORTION OF PURCHASE RULED DEDUCTIBLE

A taxpayer bought the property it occupied as a tenant and was allowed a business deduction for the portion of the purchase price attributable to an excessive lease.

ABC Beverage Corp. (then known as Beverage America) in 1995 acquired via its subsidiary another bottling company, including a lease with an option to purchase its business site in Hazelwood, Mo. A rent escalator clause in the lease made it advantageous to buy the property in 1997, the only purchase period permitted. The price under the purchase option was well above the fair market value of the property exclusive of the lease. Therefore, ABC capitalized the property at the appraised value of \$2,750,000 and deducted the difference between it and the negotiated minimum purchase price of \$9 million (it actually paid \$11 million), or \$6,250,000, as a lease termination expense. The IRS assessed a deficiency of more than \$2.46 million, for which ABC sued for a refund.

The IRS argued that IRC § 167(c)(2) prohibited any allocation of the purchase price to the leasehold interest. That provision says that none of a property's basis shall be allocated to a leasehold if it is "acquired subject to a lease." But the district court in western Michigan hearing the case held that the phrase "subject to a lease" applies to a third-party purchaser who acquires a reversion in the continuing lease, not to a lessee-purchaser whose purchase extinguishes the lease, as here. Thus, section 167(c)(2) did not apply, and the amount paid for the property could be treated separately from the amount paid for the onerous lease.

In holding for the taxpayer, the court noted that its appellate circuit, the Sixth, had allowed a business deduction for the cost of buying out an onerous lease in *Cleveland Allerton* (36 AFTR 862 (1948)). The IRS, however, contended that the precedent of *Cleveland Allerton* was nullified by the Supreme Court in *Millinery Center* (350 U.S. 456, 49 AFTR 171 (1956)). In that case, the Supreme Court reviewed a Second Circuit decision denying a deduc-

tion to a tenant-purchaser because the Sixth Circuit's *Cleveland Allerton* decision was in apparent conflict with it. The Supreme Court denied the deduction, but the district court in *ABC* said a careful analysis of *Millinery Center* indicates the reason for disallowing the deduction was a lack of evidence that the rent was onerous. In other words, the *ABC* court believed the conflict between the circuits could not be resolved in *Millinery Center* because the taxpayer in that case could not reach the factual threshold of proving an onerous lease, as the taxpayer in the instant case had.

■ *ABC Beverage Corp. v. U.S.*, 102 AFTR2d 2008-5905

By **Larry Maples**, CPA (inactive), DBA, professor of accounting, Tennessee State University, Nashville, Tenn., and **Mark A. Turner**, CPA, DBA, associate professor of accounting, University of St. Thomas, Houston.

GAINS AND LOSSES

ROYALTIES FROM RELATED PARTY ARE ORDINARY INCOME

The Second Circuit Court of Appeals affirmed the Tax Court's decision that an individual's receipt of patent royalties was ordinary income, not long-term capital gain, because the payments were made in exchange for patent rights transferred to a related corporation.

Nathaniel Garfield was a limited partner in a partnership that was majority owner of a corporation. In 1969, his general partner, Thomas McSherry, filed a patent application for an expansible fastener and the same day assigned the related patent rights to the partnership. Subsequently, the partnership transferred the patent rights to the corporation, which paid royalties to Garfield and McSherry. The IRS in 2004 notified Garfield of deficiencies in returns for 2000 through 2002 stemming from more than \$800,000 in royalties for the three years that it said Garfield erroneously characterized as long-term capital gain.

Garfield pointed to section 1235(a), which provides that a property transfer of all substantial rights to a patent is treated as a sale or exchange of a long-term capital

asset. However, the Tax Court rejected this argument because under subsection (d), the treatment is not available if the transfer was between a corporation and a related party—in the case of patent rights, a more-than-25% owner. Garfield held a 36% interest in the corporation and, before that, the partnership had held a 74% interest.

Alternatively, Garfield argued that the patent was a capital asset and that the royalty payments were long-term capital gains under sections 1221 and 1222. The courts rejected this argument also, on the basis that Garfield did not hold any patent right for more than one year as required. In addition, the courts upheld a 20% substantial underpayment penalty under section 6662(a). The Tax Court said that grounds for an exception for reasonable cause and acting in good faith were not evident where Garfield and his wife "do not contend that they followed, or even sought, the advice of a tax professional." The Second Circuit upheld the penalty while acknowledging the returns were signed by a law firm.

■ *Nathaniel H. Garfield v. Commissioner*, TC Memo 2006-267, *aff'd*, 102 AFTR2d 2008-5803 (2d Cir. 2008)

By **Jean T. Wells**, CPA, J.D., assistant professor of accounting, Howard University, Washington, D.C.

FILING STATUS

LATE RETURNS, LATE WIFE

The U.S. District Court for the Western District of Louisiana held that a taxpayer could use the married filing jointly status on delinquent tax returns for the five tax years preceding the year his spouse had died. The government unsuccessfully argued that joint status was available only for the year of his spouse's death.

Generally, a husband and wife may elect to file a joint tax return if they have the same tax year and both are U.S. citizens or residents. If one spouse dies, section 6013(a)(3) allows the surviving spouse to file a joint return with the deceased spouse if no return has been filed for the taxable year by the deceased spouse, no executor has been appointed,

and no executor is appointed before the last day a return can be filed by the surviving spouse. Treas. Reg. § 1.6013-1(d)(3) provides an example where a surviving spouse could file a joint return for 1956 and 1957 as long as the death of the other spouse in 1957 occurred before the due date of the 1956 return, assuming the other conditions of section 6013(a)(3) were met.

Donald Vidalier and his wife did not file income tax returns for the years 2000 through 2005. Vidalier's wife died on Dec. 12, 2005, and after filing a Chapter 13 bankruptcy petition in 2006, Vidalier filed delinquent joint returns for all years. The IRS permitted the joint status for 2005 but not for the other years and adjusted his bankruptcy liabilities based on the married filing separately status. Vidalier objected, but the bankruptcy court agreed with the IRS, so he appealed the decision.

The government argued that when Congress used the phrases "the joint return" and "the taxable year" (emphasis added) in section 6013(a)(3), it intended to limit the ability of a surviving spouse to file a joint return to only the year of the other spouse's death, and the joint status is not permitted on delinquent returns for previous years. It also argued that the application of Treas. Reg. § 1.6013-1(d)(3) would allow Vidalier to file a joint return only for 2005, since his wife died after the due date for the 2004 return. The district court rejected these interpretations, citing *Friedman v. Commissioner* (TC Memo 1987-6), in which the Tax Court permitted joint status on returns for 1977 and 1978 filed in 1981, even though the taxpayer's spouse had died in 1978. It stated the section 6013(a)(3) requirements are applied to each year in question and are not limited to only one year. Since Vidalier met all of the requirements of section 6013(a)(3) for each year, the court stated the joint status was permissible.

■ *Donald James Vidalier v. U.S.*, 102 AFTR2d 2008-6076

By **Charles J. Reichert**, CPA, professor of accounting, University of Wisconsin-Superior.

GAINS AND LOSSES; PASSIVE LOSS LIMITATION

PROOF OF MATERIAL PARTICIPATION MUST BE CREDIBLE

A taxpayer must prove material participation in an activity to deduct losses from that activity against nonpassive income. The Ninth Circuit reaffirmed that credible evidence must be presented to prove that one of the material participation tests of IRC § 469 has been met.

In 2007, the U.S. District Court for the Western District of Washington granted the IRS summary judgment disallowing a taxpayer's attempt to carry back losses without sufficient evidence of material participation in the family company. However, the IRS's alternate argument that the taxpayer's claim should also be disallowed pursuant to capital loss rules/limitations was rejected because it wasn't clear whether the activities in question were conducted in a dealer or trader capacity. In September 2008, the Ninth Circuit Court of Appeals upheld the decision without oral argument.

Started in the 1970s, family-run partnership Dean Securities brokered stocks and bonds. In 1998, sharp declines in securities values caused large losses for the company.

Loren Dean, a 20% partner, claimed a refund for carryback losses for 1996 based on his 1998 partnership losses. By his testimony and that of his brother/partner, Dean was unable to satisfy the court that he had materially participated for 500 hours or more in the company in 1998. The firm did not keep records of the partners' hours, nor did Dean have any other corroborating written records. The Ninth Circuit acknowledged that substantiation requirements for material participation in Temp. Treas. Reg. § 1.469-5T are "somewhat vague" but said that "ballpark guesstimates" are not enough. Therefore, Dean's losses were deemed to be passive.

Under section 469(b), passive activity losses are generally deductible only to the extent of passive activity gains. If no passive gains exist to offset the loss, the taxpayer may carry the passive loss forward to the next year.

■ *Dean v. IRS*, 99 AFTR2d 2007-988, *aff'd*, 102 AFTR2d 2008-6051 (9th Cir. 2008)

By **Laura J. Kreissl**, Ph.D., assistant professor of accounting, and **Darlene Pulliam**, CPA, Ph.D., McCray Professor of Business and professor of accounting, both of the College of Business, West Texas A&M University, Canyon, Texas.

HOBBY LOSS

IRS AUDITOR'S PUPS UNPROFITABLE

The Tax Court disallowed an IRS auditor's deductions for breeding greyhounds as a hobby loss. Ralph Thomas Whitecavage bred and raised the dogs for racing. He received a percentage of their race winnings but did not realize a profit. The IRS determined deficiencies totaling \$18,601 for tax years 2001 through 2003 stemming from nearly \$75,000 in net losses that Whitecavage claimed on Schedule C over the three years.

Under IRC § 183(b)(2), absent a primary goal of earning a profit, deductions related to an activity are allowed only to the extent of the related gross income. The taxpayer generally bears the burden of establishing a profit motive for the activity. The determination is based on all relevant facts and circumstances, with a focus on nine factors:

(1) *Manner of carrying on the activity.* Whitecavage failed to carry on his greyhound activities in a businesslike manner, since he failed to maintain complete and accurate books and records. Nor did he have a written business plan, and he did not prepare contemporaneous budgets or financial analyses.

(2) *Expertise of the taxpayer or advisers.* Extensive study of an activity, including its accepted business, economic and scientific practices, may indicate a profit motive. Whitecavage was unable to demonstrate personal expertise in running his greyhound activities profitably and had not consulted economic experts.

(3) *Time and effort expended in activity.* During the years under review, Whitecavage was a full-time IRS employee, which limited

his time spent on greyhound breeding (he retired from the Service in 2006). The operation bred only one litter of pups each year, while profitability would have required three to four litters per year, evidence indicated.

(4) *Expectation that assets may appreciate.* Although Whitecavage claimed that at least one of his greyhounds could become a winning "stakes dog" worth \$100,000 to \$250,000, his dogs generally depreciated in value. At trial, no evidence was presented that a single dog was ever sold. Further, no evidence was presented to indicate that a kennel Whitecavage built in 2002 would be sold for a profit.

(5) *Success in other activities.* Whitecavage had not previously engaged in any similar activities.

(6) *History of income or losses from activity.* Whitecavage realized losses from greyhound breeding for 10 consecutive years as of 2003.

(7) *Amount of occasional profits.* He never realized any profit. IRC § 183(d) provides a presumption of a profit motive if taxpayers show a profit in three out of five years.

(8) *Financial status of taxpayer.* Having significant financial resources from other activities may indicate lack of a profit motive. His full-time employment by the IRS provided substantial income, the court determined.

(9) *Elements of personal pleasure.* The presence of personal pleasure or recreation may indicate lack of a profit motive, as it did here, the court said.

With all nine factors weighing against Whitecavage, the Tax Court determined that he lacked a profit motive. Furthermore, the court upheld a 20% accuracy-related penalty for 2002, since Whitecavage failed to show reasonable cause and good faith regarding a substantial understatement of tax liability.

■ *Ralph Thomas Whitecavage v. Commissioner*, TC Memo 2008-203

By **Beth Howard**, Ph.D., assistant professor of accounting, and **R. Dan Fesler**, CPA (inactive), DBA, CIA, CMA, professor and chair of accounting, both of Tennessee Technological University.

Line Items

AMT RELIEF IN BAILOUT BILL

Besides "patching" the alternative minimum tax (AMT) exemption amount for 2008 (to \$69,950 for joint filers and \$46,200 for singles), the Emergency Economic Stabilization Act of 2008 (PL 110-343) increased the portion of the long-term unused minimum tax credit (MTC) that can be claimed in a year. Under prior law, the MTC allowable in a year was generally limited to the greater of \$5,000, 20% of the long-term unused MTC, or the preceding year's credit amount. Under the Act, the annual amount allowable is increased to 50% of the long-term MTC or the preceding year's credit amount.

Many taxpayers with MTCs received them as a result of AMT liability arising from exercise of incentive stock options (ISOs). Congress has several times previously passed measures providing other forms of relief for situations in which stock lost most or all its value before taxpayers could receive cash on its disposal.

The Act also abates any underpayment of tax outstanding (and interest and penalties with respect to the underpayment) on the date of its enactment (Oct. 3, 2008) arising from application of the minimum tax adjustment for ISOs in tax years ending before Jan. 1, 2008, and provides, for the first two tax years beginning after Dec. 13, 2007, for an increase in the MTC by 50% of the aggregate amount of interest and penalties paid before the date of enactment. The Act also eliminated the adjusted gross income (AGI) phaseout of the AMT refundable credit amount. The AGI phaseout of the AMT exemption amount remains in place. In addition, the Act extends for 2008 the ability to use personal nonrefundable credits to reduce the AMT.

TIGTA: UNENROLLED PREPARERS OFTEN WRONG

Unenrolled, unlicensed preparers had only a 35% accuracy rate in preparing income tax returns, in a test conducted by the Treasury Inspector General for Tax Administration.

More than one-third of the erroneous returns contained misstatements or omissions that TIGTA considered willful or reckless.

TIGTA auditors posed as taxpayers earlier this year at 12 offices of commercial tax preparation chains and 16 small, independently owned offices. Of the 28 tax returns prepared, only 11 were prepared correctly, TIGTA said. If the 17 erroneous returns had been filed with the IRS, they would have resulted in \$12,828 in underpaid taxes. TIGTA determined that six returns contained willful or reckless omissions or misstatements. Fees charged by the preparers varied widely—even among similar returns—but averaged \$234 per return at commercial chains and \$132 at independent offices.

The IRS agreed to study TIGTA's recommendation that it develop a system for identifying all paid preparers by identification number. As TIGTA noted, anyone, regardless of experience or expertise, who charges a fee may file a return on behalf of a taxpayer. Only CPAs, attorneys, enrolled agents and enrolled actuaries, however, are considered tax practitioners "enrolled" to represent taxpayers before the IRS.

In a separate, ongoing TIGTA study, volunteer preparers in the 2008 filing season were much more accurate. Checks of 36 returns at Volunteer Income Tax Assistance and Counseling for the Elderly sites in 12 cities yielded a 69% accuracy rate—all the more noteworthy, TIGTA said, for its improvement since the 2004 filing season, when the checks began. That year, in a check of 35 returns, the accuracy rate was zero.

See both reports at www.ustreas.gov/tigta. ❖

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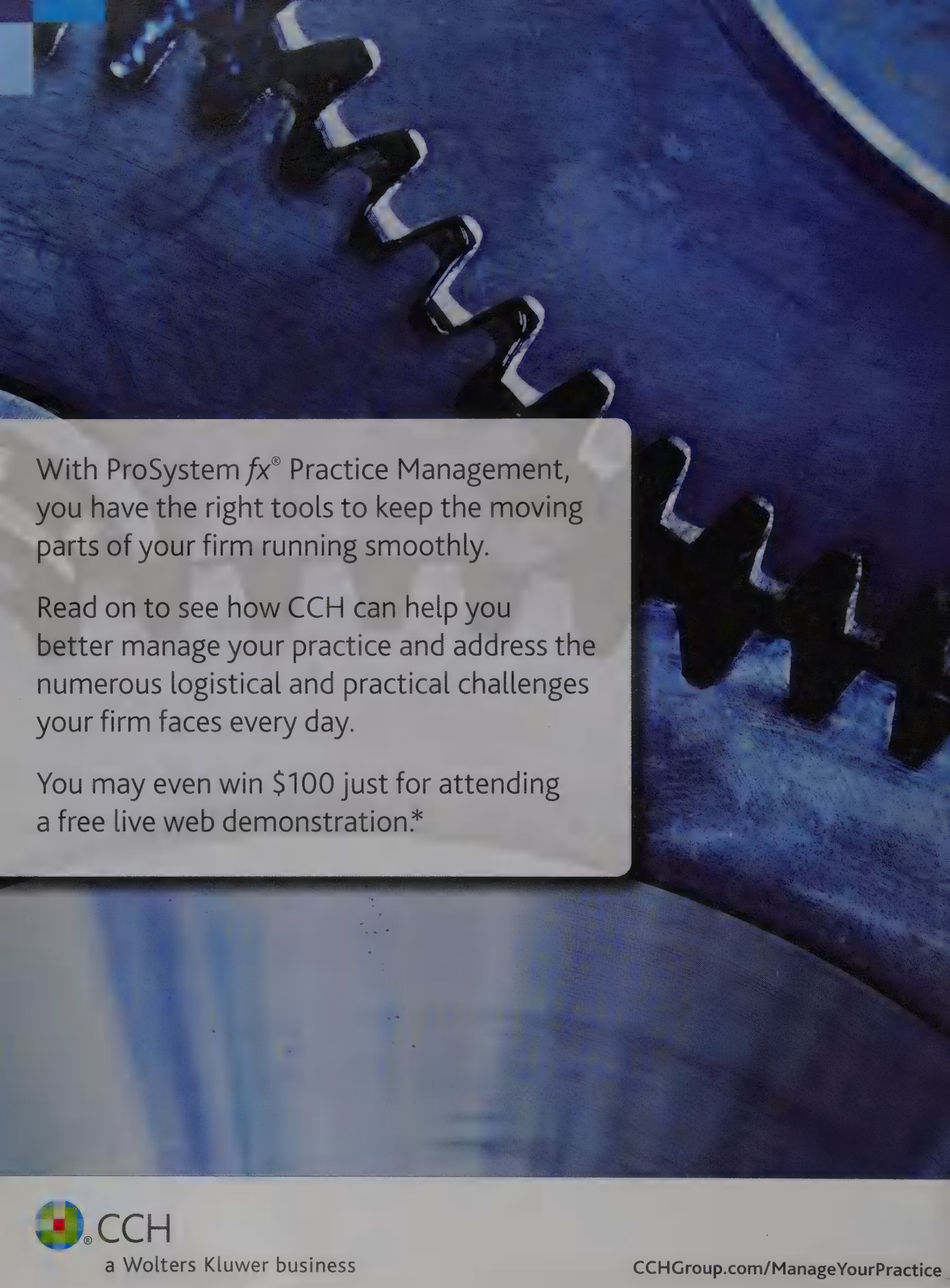
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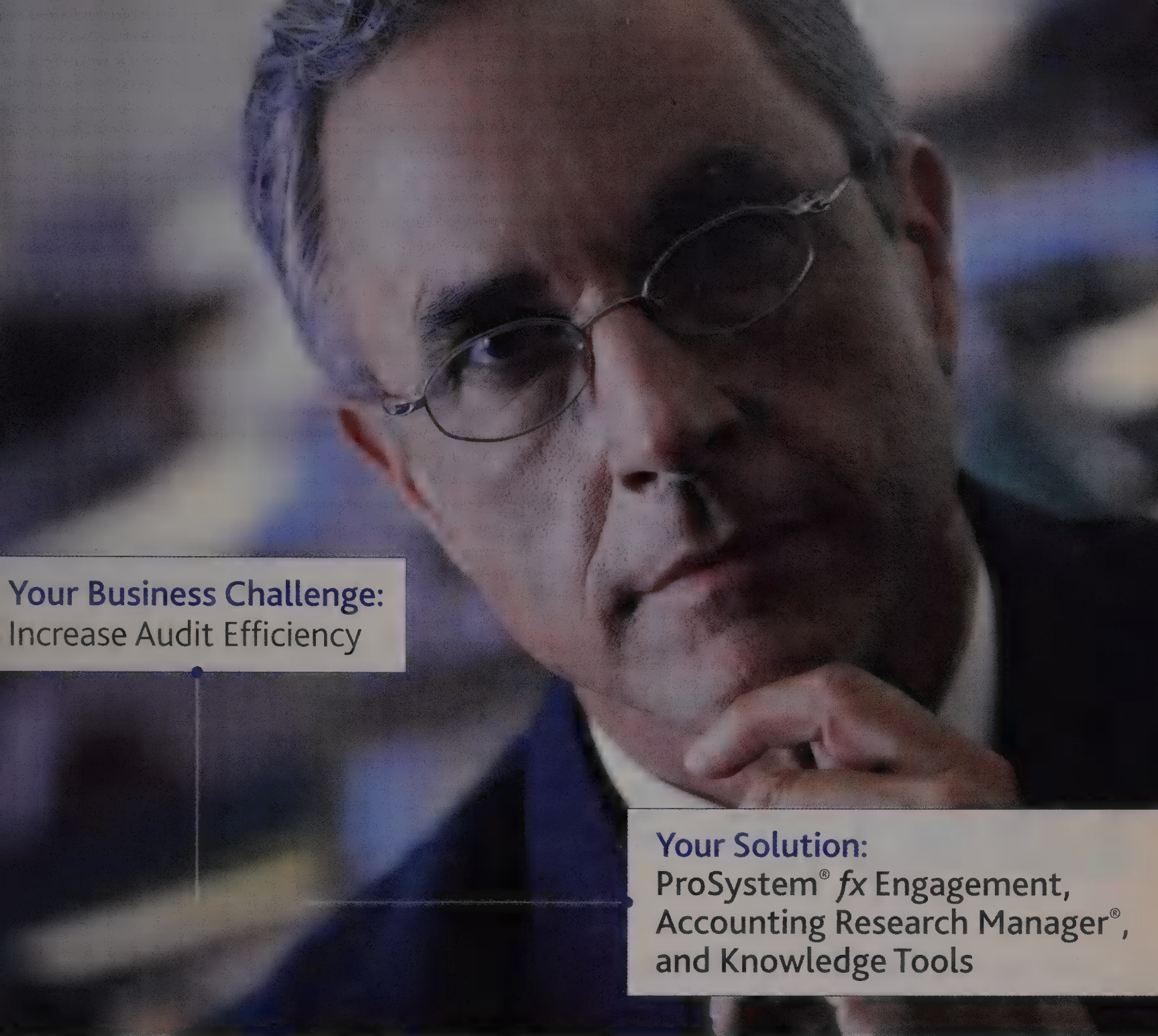
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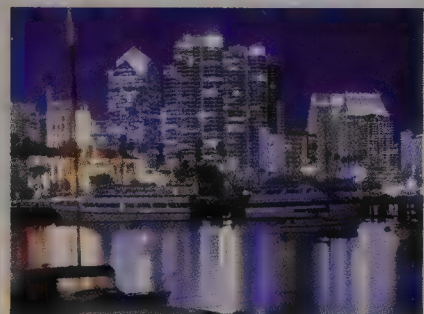
AICPA Boardroom
New York, NY
January 15-16, 2009

CPE Credits: 14.5

CONFERENCE HIGHLIGHTS:

- Branding – Making the Most of What You've Got
- What the Future Holds
- Top 10 Ways to Maximize Collateral!
- Cutting-Edge Communication Tools
- Communicating Like a Pro

AICPA Advanced Personal Financial Planning Conference



Hilton San Diego Bayfront
San Diego, CA
January 19-21, 2009

CPE Credits: 24 (main) and up to 6 (workshops)

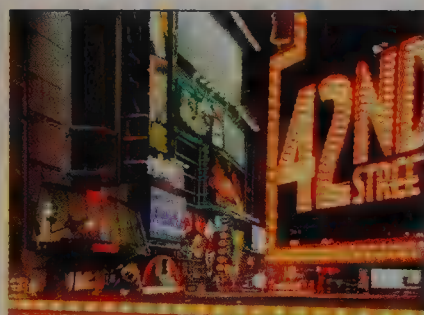
Pre-Conference Workshops
and Complimentary Thought Leadership

Sessions: Sunday, January 18th

CONFERENCE HIGHLIGHTS:

- Four Tracks: Investment Management, Practice Management, Wealth Management, PrimePlus ElderCare/Retirement
- Sixty is the New Forty
- Behavioral Finance and Investor Biases
- Dimensions of Investing
- Economic Update

AICPA Fair Value Measurement Workshop



AICPA Boardroom
New York, NY
February 26-27, 2009

CPE Credits: up to 16

WORKSHOP HIGHLIGHTS:

- Trends and other issues behind the development of fair values measurements
- Discussion of conceptual issues in estimating fair value
- Hands-on examples of measuring fair value from the perspective of an outside

AICPA International Accounting, Auditing and Tax Conference



Grand Hyatt Washington
Washington, DC
April 30-May 1, 2009

CPE Credits: 17 (main)

CONFERENCE HIGHLIGHTS:

- IFRS
- Transfer Pricing
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- Doing Business Overseas with several sessions focusing on different regions
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Bellagio
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Pre-Conference Workshops and Complimentary Thought Leadership Sessions: Sunday, May 3, 2009

CONFERENCE HIGHLIGHTS:

- Economic and Financial Outlook – Jonathan Pond
- Technology Update for All Size Firms
- Managing Professional Risk
- Mentoring Should Not be a Cover-up for Poor Management – Rebecca Ryan

AICPA Conference on Tax Strategies for High Income Individuals



Bellagio
Las Vegas, NV
May 7-8, 2009

CPE Credits: 24 (main) and up to 8 (workshops)
Pre-Conference Workshops :
Wednesday, May 6, 2009

CONFERENCE HIGHLIGHTS:

- Committee Chair: Sid Kess & his All-Star speaker
- Individual Income Tax Update
- Tax Planning for Real Estate Transactions
- Best Tax Ideas Panel
- International Tax Planning

AICPA National Conference on Employee Benefit Plans



Rosen Shingle Creek
Orlando, FL
May 18-20, 2009

CPE Credits: up to 21(main) up to 12 (workshop)
Pre-Conference Workshops:
Sunday, May 17, 2009

CONFERENCE HIGHLIGHTS:

- Addresses both the tax and audit side of employee benefit plans
- Up-to-date regulatory information
- Practical guidance and tools
- Latest on the Employee Benefit Audit Quality Center

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AICPA Boardroom
New York, NY
May 4-8, 2009

▶ AICPA National Banking School

University of Virginia McIntire
School of Commerce
Charlottesville, VA
May 10-15, 2009

▶ NEW! AICPA CFO Forum

Hilton La Jolla Torrey Pines
San Diego, CA
May 14-15, 2009

PARTIAL GAIN FROM SALE OF PRINCIPAL RESIDENCE

New Treatment for Second-Home Proceeds

The 2008 Housing and Economic Recovery Act, enacted in late July, changes the rules for the partial exclusion of gain from the sale of a residence. For sales after Dec. 31, 2008, the IRC § 121 exclusion of gain will not apply to any gain allocated to a period of "nonqualified use." Prior to this, taxpayers simply had to meet the two-year ownership and use tests to qualify for the partial exclusion.

Under the new rules, taxpayers will have to determine the amount of gain (if any) allocable to periods of nonqualified use. Gain will be allocated to periods of nonqualified use based on the ratio that aggregate periods of nonqualified use bear to the period the taxpayer owned the property.

A period of nonqualified use is defined as any period in which the property is not used as the taxpayer's principal residence (or as the principal residence of the taxpayer's spouse or former spouse). Note that no period before Jan. 1, 2009, will be considered a period of nonqualified use. And periods when the homeowner did not live in the residence due to military service, change of employment, health conditions or other unforeseen circumstances also do not count as periods of nonqualified use.

Before this, taxpayers who owned more than one residence could exclude up to \$250,000 (\$500,000 for married taxpayers filing jointly) of gain on the ultimate disposition of these residences, provided that the ownership and use time requirements of section 121(a) were satisfied for each residence. The maximum exclusion was available to these taxpayers even if the second residence had previously been a rental property, an investment property, a vacation property or property used in a trade or business.

The new provision reduces the amount of gain that taxpayers can exclude when they move into what had been their second home. Some gain from periods before the second home became the principal residence will have to be recognized.

NONQUALIFIED USE EXTENDS BEYOND "RESIDENCE"

The new amendments to section 121 use the word "property"

rather than "residence" to ensure broad application of the provision. It therefore appears that nonqualified use includes the period of time that a taxpayer owns a vacant lot on which he or she intends to construct his or her primary residence before that residence is constructed and occupied.

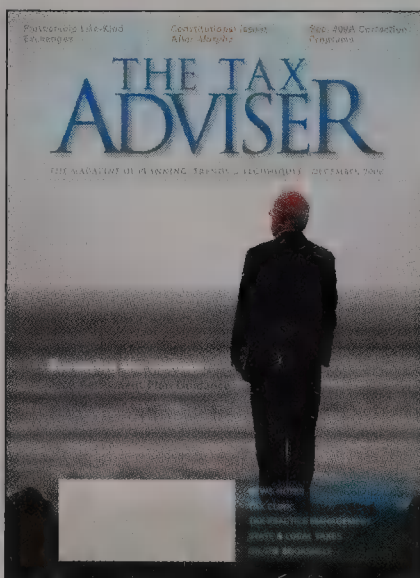
EXCEPTIONS

The new rules contain two exceptions. First, homeowners can move out of their primary residence and convert it to nonqualified use property such as rental, investment or vacation property and still be eligible for the full exclusion, as long as the homeowner meets the other requirements of section 121 at the date of disposition.

Second, a period of nonqualified use does not include a period of temporary absence, which is defined as a period of absence "due to change of employment, health conditions, or such other unforeseen circumstances" with the period not exceeding an aggregate of two years.

For a detailed discussion of the issues in this area, see "New Rules Seek to Reduce Tax Advantages of Converting Second Home to Principal Residence," by Kevin Rose, CPA, CFP, in the December 2008 issue of *The Tax Adviser*.

—Alistair M. Nevius, editor-in-chief
The Tax Adviser



Also look for articles on the following subjects in the December 2008 issue of *The Tax Adviser*:

- A look at recent trends in sales and use tax nexus.
- A discussion of like-kind exchanges of partnership properties.
- An update on qualified retirement plan developments.

Notice to Readers:

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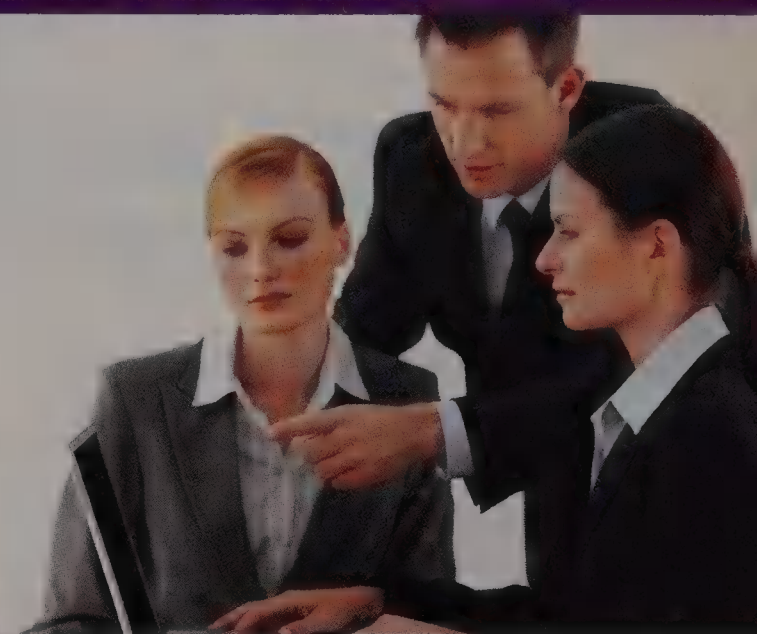
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Technology Q&A

by Stanley Zarowin

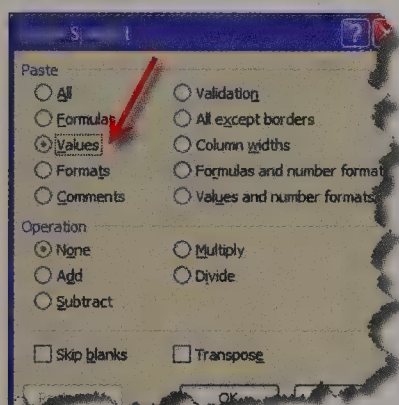
Reverse the order of a long list in Excel...Use a template to spare you the labor of formatting a frequently used special-needs worksheet...Create a shortcut for easy access to System Restore...

A quick way to erase selected data from a workbook...

Generate duplicate changes in multiple Excel worksheets...Shortcuts

REVERSE THE ORDER OF A LONG LIST IN EXCEL

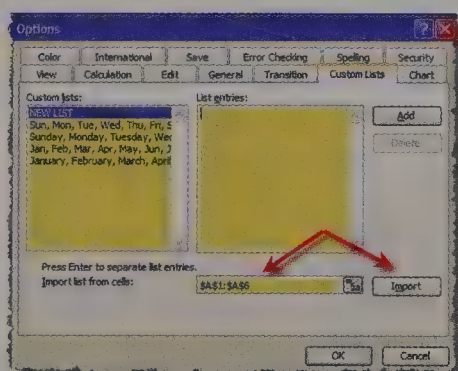
Q Every now and then I have to reverse the order of a long list in Excel that is not in alphabetical or numerical order—a tedious job. Do you know of a shortcut?



A Yes, you can adapt **Custom Lists**, a tool you should become familiar with because it is versatile and very handy. Once I show you how to adapt it to reverse a list, you'll quickly see how you can use it for other functions as well.

First, copy (Ctrl+C) the whole list (One, Two, Three... Six) and then paste it in another location (any empty space in your worksheet or to a new worksheet) by right-clicking and selecting **Paste Special, Values, OK** (see screenshot above).

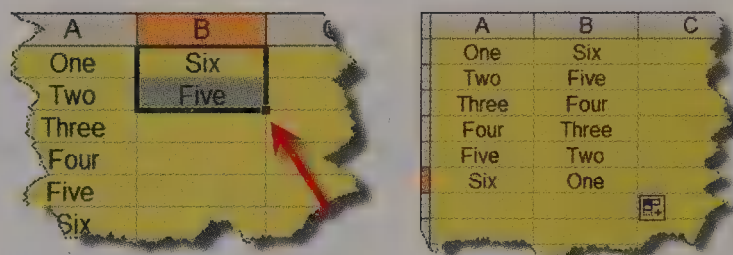
Then select the whole list and go to **Tools, Options, Custom Lists**. Notice that the copied list address appears at the bottom of the screen (see screenshot at right).



Click on **Import** and the list itself will appear (see screenshot at left).

Now comes the neat part. Go back to an empty column next to the original list and enter the last item in your

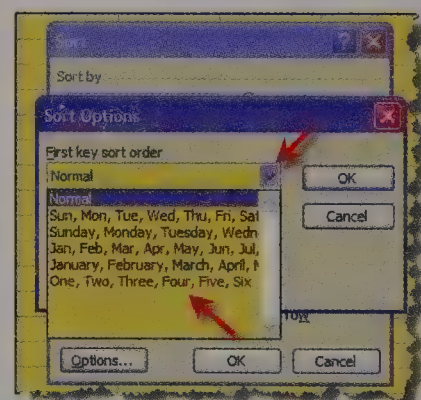
original list (Six) at the top of the column. Then enter the second from last item (Five) under that; that gives Excel the critical clue to the sequence you wish—reversing the list. Finally, select both cells and double-click on the **Fill Handle** (small black square) and the whole list, in reverse, will fill the column.



If you return to **Custom Lists (Tools, Options)**, you'll see your list under **Custom Lists**.

When you're finished with the custom list, you can erase it, if you wish, by highlighting it and clicking on **Delete**.

As you can see, it's a handy little tool when dealing with custom lists.

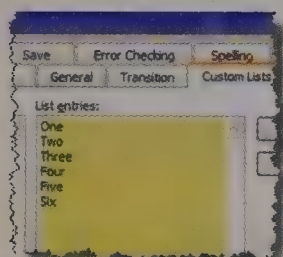


» Key to Instructions

To help readers follow the instructions in this article, I use two typefaces:

Boldface type is used to identify the names of functions, menu items, icons, agendas and URLs.

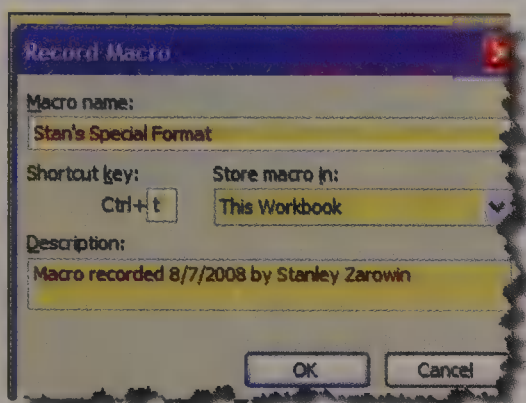
Sans serif type indicates the names of files and the names of commands and instructions that users should type into the computer.



USE A TEMPLATE TO SPARE YOU THE LABOR OF FORMATTING A FREQUENTLY USED SPECIAL-NEEDS WORKSHEET

Q I use a spreadsheet for my work that's formatted in a very complicated way. So every time I open a new worksheet, I have to go through all the preliminary format setup steps to prepare it for my special requirements—such as columns with varying widths and even different colors for numbers in certain rows. Is there some way to adjust Excel to do that time-consuming setup for me?

A You can create a macro to do that by clicking on **Tools**, **Macro**, **Record New Macro**, and then, after you type in where you want the macro stored and add a **Shortcut key** and a **Description**, click on **OK** and...

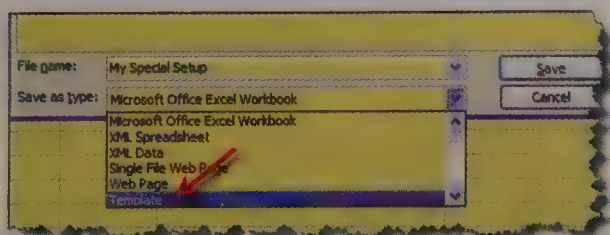


...then go through all the formatting steps. When you're finished, click on the **Stop Recording** button (see screenshot at left).

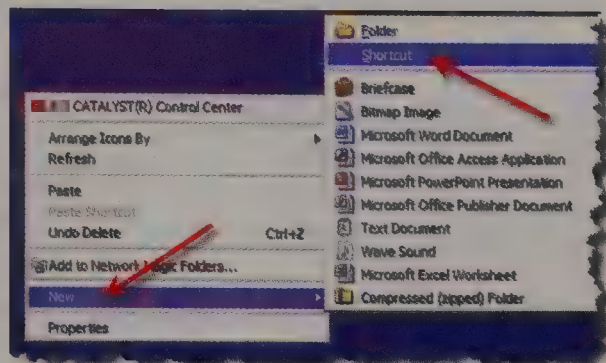
Another way—and one that I personally prefer because it's so simple and avoids some of the security drawbacks inherent with macros—is to create a template of your ideal worksheet. Then, when you need your special worksheet, just one click brings it up. You can evoke it as many times as you wish. In fact, if you like the template idea, you may even want to set up a group of templates—one for each unique setup (whether in Excel or Word, for that matter) and then create a folder to store them and a shortcut for the collection on your desktop for convenient access.

By the way, a template stores not just formatting (borders, shading, etc.), it also stores column and row headings, and even charts and formulas and toolbars for customized features. So you see, it can be quite powerful.

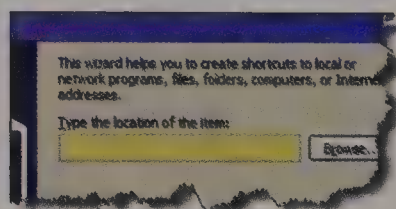
To create a template, open a new Excel file and set up your model worksheet. Then save it (Ctrl+S) to a convenient folder using the **Template** designation (see screenshot below). If you're starting from an existing file, you must use the **Save As** command.



Then, to create a shortcut, go to your desktop, right-click, and then click on **New**, **Shortcut** (see screenshot below)...



...and fill in the required information to locate the template.



Unlike ordinary shortcuts, templates have a well-deserved golden crown (see screenshot at right).



CREATE A SHORTCUT FOR EASY ACCESS TO SYSTEM RESTORE

Q I've been told that any time I make a major change in my computer—such as installing new software or new hardware—I should create a new **System Restore** point. But that function is buried under many layers, and so, when I'm busy, more often than not I fail to follow my own wise advice. Is there some easy way to launch it so I'd be more inclined to do it?

A You were given good advice. It's not uncommon for a change in your computer setup to trigger problems. The **System Restore** function is designed to save your computer's settings to an earlier time when it was operating correctly, and then, when evoked, returns your computer's settings to that earlier, healthy state. Although the restoration will revert your settings, turning the clock back will not cause you to lose any data—files or e-mail. Only the settings will revert.

Although a major systems change in your computer will automatically trigger the creation of a new restore point, called a *system checkpoint*, you also can initiate the action yourself, and, as you say, if you have the triggering mechanism handy, it's more likely you'll take advantage of it.

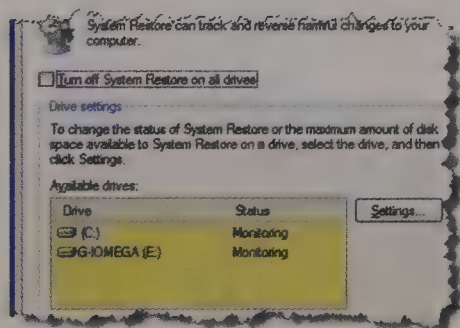
To create a shortcut, click on **Start**, **All Programs**, **Accessories**, **System Tools**, and right-click on **System Restore**. Then select **Create shortcut** and drag the shortcut onto your desktop. If you don't want the shortcut on your desktop, you can put it in your **Start** menu instead (that's where system icons appear stacked in a column when you click on your **Start** button). To put it there, instead of clicking on **Create a shortcut**, click on **Pin to Start menu**. ➤

While you're there, customize its settings so it meets your particular needs. When you first open the **System Restore** screen, you have the option to adjust its settings by clicking on **System Restore Settings**.

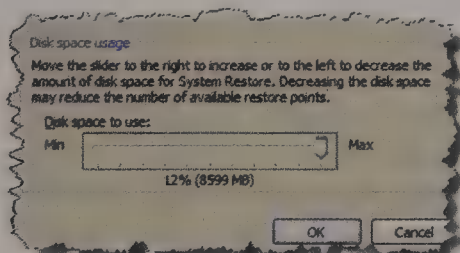
Your computer automatically creates restore points (called system checkpoints), but you can also use System Restore to create your own restore points. This is useful if you are about to make a major change to your system, such as installing a new program or changing your registry.

System Restore Settings

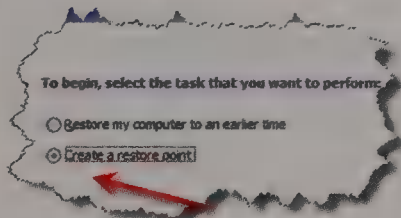
You also have the option of turning it off (not recommended) and selecting which drives you want monitored. Since I keep all my system files on the C: drive, using the G-Iomega drive for backup only, I only activate C:.



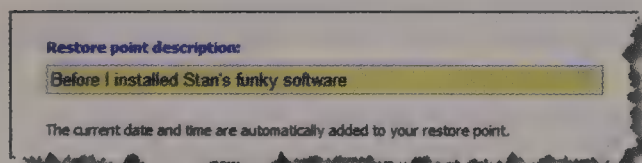
Click on the **Settings** button to bring up the **Disk space usage** screen, where you can adjust how much of the C: drive to reserve for restore point storage. I would suggest setting it to **Max**. Then click on **OK**.



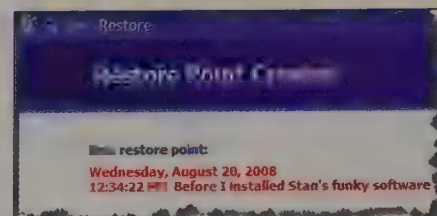
Now create a system checkpoint. Return to the opening screen and click on **Create a restore point**.



Add a description for your checkpoint and click on **Create** at the bottom of the screen.



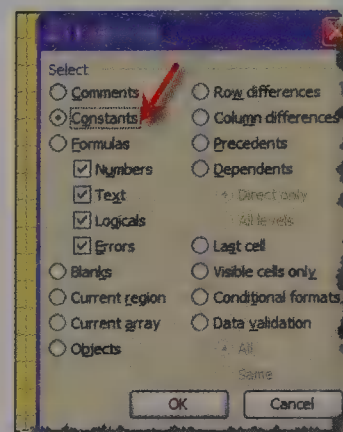
After a few seconds, when this screen appears (see screenshot atop the next column), the checkpoint has been recorded.



A QUICK WAY TO ERASE SELECTED DATA FROM A WORKBOOK

Each year I take some of my prior-year Excel workbook and delete all the old data except for the formulas—a tedious process. Is there a better way to do this?

Excel has a tool for that. Highlight the area of the worksheet you want cleared. In this case, since the data is scattered throughout the entire worksheet, press **Ctrl+A**. However, if you want to save your labels, just highlight the range you want cleared. Don't worry, this won't erase your formulas. Now press **F5**, which brings up the **Go To** menu, and then click on **Special**, evoking the **Go To Special** screen (see screenshot on right). Since you only want the numbers erased—the constants—click on the **Constants** radio button.



Click **OK**. If you want comments removed also, return to the **Go To** menu and click on that button.

Now press the **Del** key, and the worksheet is immediately ready for next year—with all the constants removed but all the formatting and formulas in their proper place.

GENERATE DUPLICATE CHANGES IN MULTIPLE EXCEL WORKSHEETS

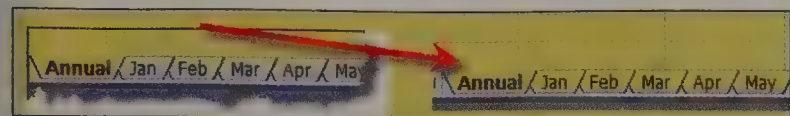
I usually set up my annual budget in one Excel workbook and then I add 12 more sheets—one for each month of the year—so I can easily track the monthly data. Each sheet contains the same rows, columns and formulas. Only the headings on each worksheet are different, along with the raw data for each month of course. I use this setup because I was told it would make it easy for me to keep all the worksheets in sync—that is, if I make changes in the annual budget sheet, say, that change will be duplicated in the corresponding cells in all the monthly sheets—all in one swoop. Sounds great, except I can't figure out how to do it. Can you help?

It's a very simple process. In this example, let's say you want to change the 2009 Budget for Plant C (see screenshot below) from \$44,000,000 to \$56,700,000, and you want that change to be reflected in all 12 monthly sheets.

	A	B
1		2009 Budget
2	Plant A	21,000,000
3	Plant B	34,500,000
4	Plant C	44,000,000

Select the tab for the first worksheet in the series; in this case it's **Annual** (see screenshot on the next page). Hold down the **Shift** key as you

click on the tab of the *last* sheet in the series in which you want the change reflected (that would be **May**). Notice how all the tabs change color—indicating that you’ve “linked” them.



Notice, too, that Excel also added the word [Group] to the title bar to alert you that you have a group of worksheets selected; as you’ll see, that alert is important.

Now make your changes to the worksheet that appears on the screen; they will now be simultaneously copied to the corresponding cells in every other linked sheet as well.

Stan Corp. Budget [Group]

	A	B
1		2009 Budget
2	Plant A	21,000,000
3	Plant B	34,500,000
4	Plant C	44,000,000

	A	B		A	B
1		2009 Budget	1		Jan Budget
2	Plant A	21,000,000	2	Plant A	21,000,000
3	Plant B	34,500,000	3	Plant B	34,500,000
4	Plant C	56,700,000	4	Plant C	56,700,000
5			5		

Important: When done, be sure to click on a tab of any worksheet *other than* the first in the range. That deselects the link with

all the sheets. If you fail to do that, any subsequent changes you make will continue to be copied in all the other sheets, and that could lead to quite a mess.

SHORTCUTS

- Ctrl+I: Opens the **Format Cells** menu
- Ctrl+Shift+&: Places a border around a cell or group of highlighted cells
- Ctrl+Shift+-: Removes the border
- Ctrl+Shift+,: Turns a cell or highlighted row or column into a dollars-and-cents format
- Windows logo key+E: Opens Windows Explorer

Stanley Zarowin is a contributing editor to the *JofA*. His e-mail address is stanley.joatech@gmail.com.

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution? Send them to me via e-mail at stanley.joatech@gmail.com or via regular mail at the *Journal of Accountancy*, 220 Leigh Farm Road, Durham, NC 27707-8110.

Because of the volume of mail, I regret I cannot individually answer submitted questions. However, if a reader’s question has broad interest, I will answer it in a forthcoming Technology Q&A column.

AICPA Publications

New!

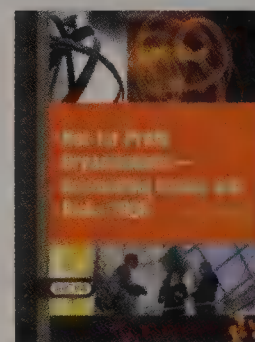
Not-for-Profit Organizations Accounting Issues and Risks 2008: Strengthening Financial Management and Reporting--Financial Reporting Alert

Designed for members of an entity’s financial management and audit committee, this Financial Reporting Alert identifies current accounting and regulatory developments affecting an entity’s financial reporting.

It is intended to help you achieve a more robust understanding of the economic and business environment in which your entity operates and is also an important tool in identifying the significant risks that may result in the material misstatement of your entity’s financial statements.

Specifically, in this alert you will find information on recent issues that affect your organization such as:

- The state of the economy and its affect on not-for-profit organizations
- IRS activities that impact exempt organizations
- The Hierarchy of Generally Accepted Accounting Principles (FASB No. 162)
- Disclosures about Derivative Instruments and Hedging Activities (FASB No. 161)



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Gary R. Kabureck



Paul J. MacDonald

THREE INDUCTED INTO BUSINESS AND INDUSTRY HALL OF FAME

Mike Harreld Jr., Gary R. Kabureck and Paul J. MacDonald were the 2008 inductees into the AICPA Business and Industry Hall of Fame.

Harreld, executive vice president and CFO of Southern Co. Transmission in Atlanta, has directed programs to reduce administrative costs through technology and provided leadership and direction for the company's Sarbanes-Oxley 404 compliance efforts. He is also responsible for significantly reducing interest costs by refinancing \$3 billion of long-term debt.

Kabureck, corporate vice president and chief accounting officer of Xerox Corp. in Norwalk, Conn., played an important role in aligning the accounting and internal control organizations with the company's new business model after a significant turnaround period. He led the Xerox implementations of the Sarbanes-Oxley Act and other regulatory initiatives and has been a strong supporter of the recruitment, training, promotion and mentoring of CPAs.

MacDonald, vice president of finance

for the Detroit Red Wings, oversees an \$80 million to \$100 million budget for the NHL franchise. He manages a wide range of operations, including all daily accounting functions, budgeting, internal and external reporting, audits, insurance, and tax matters. In his tenure with the Red Wings, MacDonald has played an integral part in cutting costs.

The AICPA Business and Industry Hall of Fame honors CPAs who provide insight and vision to their organizations, understand all facets of their enterprise and demonstrate the leadership, commitment and strategic ability necessary to help their organizations meet the challenges of today's dynamic market conditions.

The three finalists were chosen by a panel of judges assembled by the AICPA and were presented with the honor at the Fall Controllers Workshop in Lake Buena Vista, Fla.

MILANO RECEIVES BETA ALPHA PSI'S PRESIDENT'S AWARD

Bernard J. Milano, president and trustee of the KPMG Foundation, received Beta Alpha Psi's President's

Award, the organization's highest honor.

Milano was BAP president from 1999 to 2000. Stephanie Bryant, director of the University of South Florida's School of Accountancy and BAP's 2007-2008 international president, presented the award during a lunch at the BAP national convention in Anaheim, Calif.

Bryant said that under Milano's leadership, BAP broadened its scope beyond accounting students to include finance and information systems students and led the creation of the annual Community Service Day in which volunteer members work to improve towns and cities.

Milano also helped find funding for BAP's superior chapter model, which awards cash to chapters with high levels of volunteer and professional activity.

Beta Alpha Psi is an honorary organization for accounting and financial information students and professionals.



Bernard J. Milano

WORKSHOP ADDRESSES LACK OF WOMEN CPAs IN LEADERSHIP

The AICPA Women's Initiatives Executive Committee held a workshop in Chicago in September to promote the retention and advancement of women within the accounting profession.

Women comprise 50% of the CPA talent pool. However, they make up only 20% of accounting firm partners and shareholders.

Discussions and panels during the workshop, "Retaining and Developing Women Leaders," focused on creating a firm's strategy to reverse this trend and make their firm's senior level management more diverse and allow them to serve a more varied client base.

Participants included 34 CPAs from 16 firms. They discussed their firms' statistics, including turnover rates, and promotion and hiring trends.

"Firm leaders left the workshop with everything they need to kick off an initiative including a business case document and action plan customized to their firm," Mary Bennett, lead instructor, course developer and partner at Crowe Horwath LLP in Atlanta, said in a news release.

CPEXPRESS CELEBRATES MILLIONTH SUBSCRIBER

Navzer Hormazdi, a CPA in Vancouver, Wash., became the millionth subscriber to earn continuing professional education credit through CPEExpress, the AICPA's online education program.

Hormazdi will receive a complimentary two-year subscription to CPEExpress.

CPEExpress was introduced in 2000 as Infobytes and renamed in 2006 after a complete revision that included new functionality and an enhanced look and feel. CPEExpress now offers 1,200 hours of CPE, divided into one- and two-credit courses that can be accessed 24 hours a day, seven days a week. It can be used to earn CPE credit or to review a particular subject, and it automatically keeps track of completed courses. More than 900 courses, organized by topic areas, are available.

NEW FEED THE PIG CURRICULUM TARGETS YOUNGER AUDIENCE

The AICPA and The Advertising Council have developed Feed the Pig for Tweens, a new financial literacy curriculum for fourth-, fifth- and sixth-graders.

The program is an extension of the Feed the Pig campaign, featuring Benjamin Banks, which was designed to help 25- to 34-year-olds take control of their finances.

Feed the Pig for Tweens was developed by JMH Education, with input from its Teacher Advisory Board in cooperation with the National Council of Teachers of Mathematics. The curriculum introduces students to responsible financial decision making and reinforces math skills with real-life applications.

Teachers may order printed copies or download the curriculum free at <http://feedthepig.org/tweens>.

AICPA Publications

New Edition!

Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses, 3rd Edition

By Gary R. Trugman, CPA, ABV, MCBA, ASA, MVS

The new third edition of Gary Trugman's classic guide provides a comprehensive treatment of business valuation basics and delivers practical applications for using business valuation theory in your practice. An accompanying CD-ROM includes sample reports for immediate use.

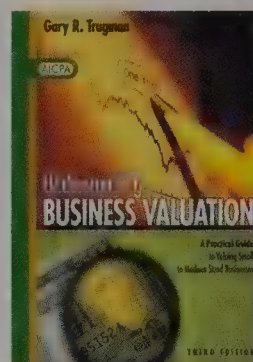
Expert praise for the new third edition—

"Gary Trugman has done it again. The third edition provides a wide-ranging and practical introduction to the field... You'll be glad this book is in your library."

— Z. Christopher Mercer, ASA, CFA

"...Packed with useful information that is written in Mr. Trugman's usual easy-going style. He presents difficult technical material in basic language that is actually fun to read... Very well done."

— James R. Hitchner, CPA/ABV, ASA



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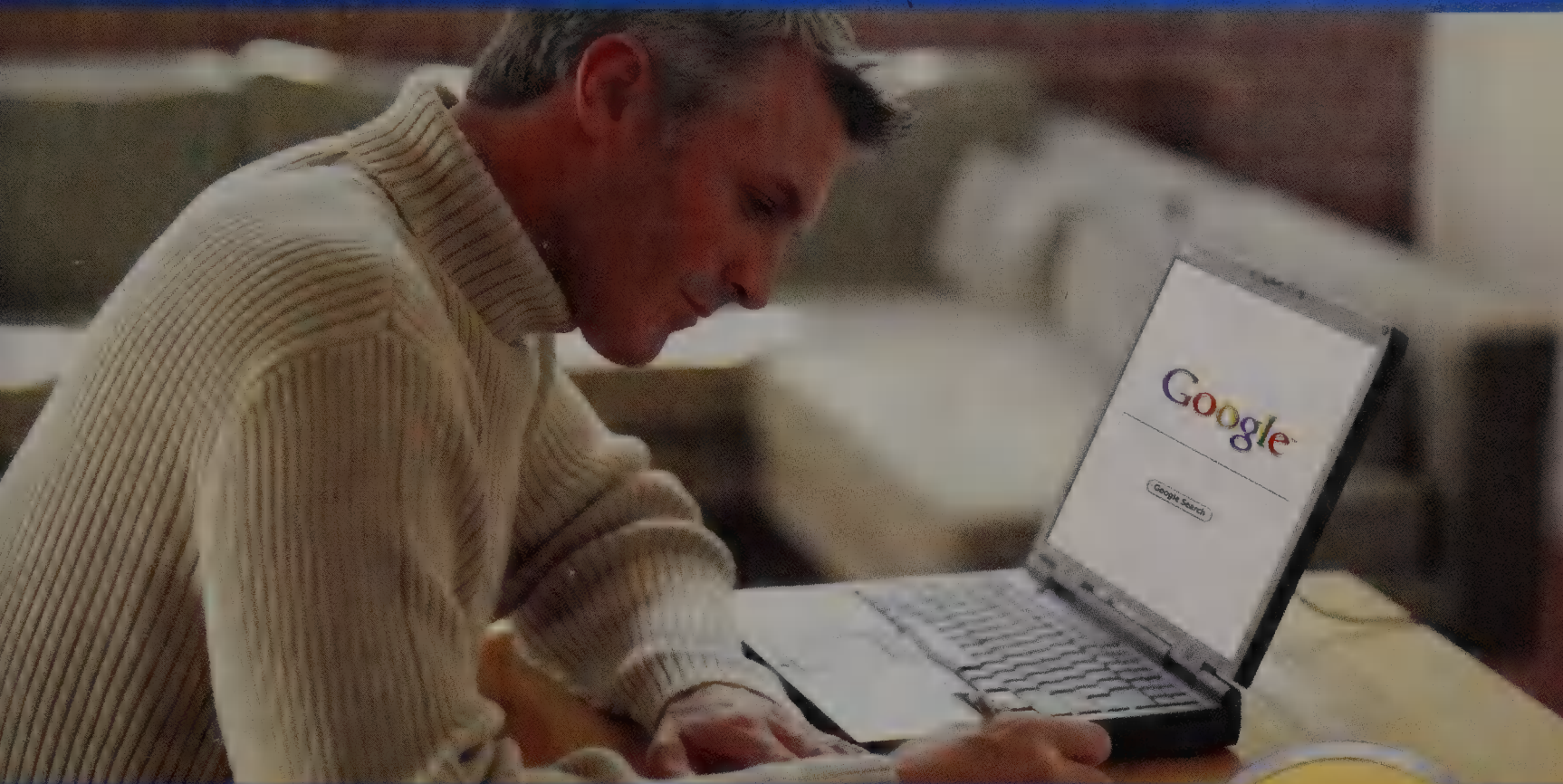
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EXPOSURE DRAFTS OUTSTANDING

(This list was compiled as of Oct. 17, 2008. More current information may be available in *The CPA Letter* or at www.aicpa.org.
Note: The policy for updating the list of exposure drafts is that a document should remain on the list until a final document has been issued or the project has been dropped. However, no comments will be received after the comments deadline has expired.
 The list is not all-inclusive but is intended to present the exposure drafts of particular interest to professional accountants.)

Issue Date	Title or Description	Comment Deadline	Issue Date	Title or Description	Comment Deadline
FASB			SEC		
10/9/08	Subsequent Events	12/8/08	6/26/02	Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process; Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624	9/3/02
10/9/08	Going Concern	12/8/08	5/10/02	Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (Release Nos. 33-8098; 34-45907)	7/19/02
9/15/08	Accounting for Transfers of Financial Assets (an amendment of FASB Statement No. 140)	11/14/08	4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 33-8090	6/24/02
9/15/08	Amendments to FASB Interpretation No. 46(R)	11/14/08	4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 34-45742	6/24/02
8/7/08	Earnings per Share—an amendment of FASB Statement No. 128 (Revision of Exposure Draft Issued September 30, 2005)	12/5/08	2/18/00	SEC Concept Release: International Accounting Standards	5/23/00
6/6/08	Accounting for Hedging Activities (an amendment of FASB Statement No. 133)	8/15/08	1/21/00	Supplementary Financial Information	4/17/00
6/5/08	Disclosure of Certain Loss Contingencies (an amendment of FASB Statements No. 5 and 141(R))	8/8/08	GASB		
5/29/08	Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information	9/29/08	8/28/08	Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards	10/30/08
10/9/06	Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition (an amendment of FASB Statement No. 142)	1/29/07	8/28/08	The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments	10/30/08
10/9/06	Not-for-Profit Organizations: Mergers and Acquisitions	1/29/07	7/31/08	Suggested Guidelines for Voluntary Reporting of SEA Performance Information	10/31/08
8/11/05	Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140	10/10/05	7/17/08	Determining the Annual Required Contribution Adjustment for Postemployment Benefits	9/30/08
AcSEC (AICPA)			4/4/08	Service Efforts and Accomplishments Reporting—an amendment of GASB Concepts Statement No. 2	7/3/08
9/10/08	Proposed Audit and Accounting Guide, Gaming	12/9/08	2/29/08	Fund Balance Reporting and Governmental Fund Type Definitions	6/30/08
9/12/07	Proposed Audit and Accounting Guide, Airlines	12/15/07	IFAC		
ASB (AICPA)			9/3/08	IPSAS 5 "Borrowing Costs" (Revised 200X)	1/7/09
9/26/08	Proposed Preface to the Codification of Statements on Auditing Standards, Principles Governing the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, and Proposed Statement on Auditing Standards, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards	12/30/08	7/15/08	Code of Ethics for Professional Accountants	10/15/08
9/2/08	Interim Financial Information	11/3/08	6/23/08	Costing to Drive Organizational Performance	9/12/08
9/2/08	Proposed Statement on Auditing Standards, Audit Considerations Relating to an Entity Using a Service Organization	11/30/08	6/23/08	Evaluating and Improving Governance in Organizations	9/12/08
9/2/08	Proposed Statement on Standards for Attestation Engagements, Reporting on Controls at a Service Organization	11/30/08	3/10/08	Accounting and Financial Reporting for Service Concession Arrangements	8/1/08
5/9/05	Proposed Statement on Auditing Standards: Amendment to Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities	6/27/05	3/6/08	Social Benefits: Disclosure of Cash Transfers to Individuals or Households	7/15/08
OTHER (AICPA)			1/15/08	Proposed Redrafted International Standard on Auditing ISA 210 (Redrafted), Agreeing the Terms of Audit Engagements	4/15/08
8/13/07	Proposal of Professional Ethics Division, Interpretation on Networks and Network Firms and Proposed Related Definitions	11/13/07	1/15/08	Proposed Redrafted International Standard on Auditing ISA 710 (Redrafted), Comparative Information—Corresponding Figures and Comparative Financial Statements	4/15/08
5/15/07	Proposed Interpretation 102-7, Other Considerations: Meeting the Objectives of the Fundamental Principles, and Proposed Framework for Meeting the Objectives of the Fundamental Principles	8/15/07	12/21/07	Proposed New International Standard on Assurance Engagements ISAE 3402, Assurance Reports on Controls at a Third Party Service Organization	5/31/08
3/7/01	Statement on Standards for Continuing Professional Education Programs	8/1/01	12/21/07	Proposed New International Standard on Auditing ISA 265, Communicating Deficiencies in Internal Control	4/30/08

EXPOSURE DRAFTS OUTSTANDING

Issue Date	Title or Description	Comment Deadline
12/21/07	Proposed Revised and Redrafted International Standard on Auditing ISA 402 (Revised and Redrafted), Audit Considerations Relating to an Entity Using a Third Party Service Organization	4/30/08
12/21/07	Proposed Redrafted International Standard on Auditing ISA 501 (Redrafted), Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures	3/31/08
12/21/07	Proposed Redrafted International Standards on Auditing ISA 520 (Redrafted), Analytical Procedures	3/31/08
10/15/07	Proposed Revised and Redrafted International Standard on Auditing ISA 505 (Revised and Redrafted), External Confirmations	2/15/08
10/15/07	Proposed Revised and Redrafted International Standard on Auditing ISA 620 (Revised and Redrafted), Using the Work of an Auditor's Expert	2/15/08
10/1/07	Consultation Paper—Proposed Strategy for 2009–2011	11/30/07
9/5/07	Amendments to IPSAS 4, The Effects of Changes in Foreign Exchange Rates	12/31/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 700 (Redrafted), The Independent Auditor's Report on General Purpose Financial Statements	11/30/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 800 (Revised and Redrafted), Special Consideration—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	11/30/07
8/3/07	Proposed Redrafted International Standard on Auditing ISA 805 (Revised and Redrafted), Engagements to Report on Summary Financial Statements	11/30/07
5/1/07	ISA 500 (Redrafted), Considering the Relevance and Reliability of Audit Evidence	9/15/07
12/29/06	Proposed Revised Section 290 of the Code of Ethics for Professional Accountants, Independence—Audit and Review Engagements, and Proposed Section 291, Independence—Other Assurance Engagements	4/30/07
12/1/06	Strategic and Operational Plan, 2007–2009	2/28/07

Issue Date	Title or Description	Comment Deadline
11/22/06	Proposed Amendment to International Public Sector Accounting Standard, "Financial Reporting Under the Cash Basis of Accounting," "Financial Reporting Under the Cash Basis of Accounting—Disclosure Requirements for Recipients of External Assistance"	3/31/07
FASAB		
9/2/08	Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government	1/5/09
3/26/08	Distinguishing Basic Information, Required Supplementary Information, and Other Accompanying Information	6/26/08
8/3/07	Reporting Gains and Losses From Changes in Assumptions and Selecting Discount Rates and Valuation Dates	1/15/08
5/21/07	Accounting for Federal Oil and Gas Resources	1/11/08
10/23/06	Accounting for Social Insurance, Revised (Preliminary Views)	4/16/07
PCAOB		
2/26/08	Proposed Auditing Standard—Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards	5/12/08
10/17/07	An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies	12/17/07
5/24/07	Amendments to Limit Board Rule 4003's Fixed Periodic Inspection Requirement to Firms That Regularly Issue Audit Reports	7/23/07
4/3/07	Proposed Auditing Standard—Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards	5/18/07
12/19/06	Amendments to Board Rules Relating to Inspections	2/16/07
5/23/06	Proposed Rules on Succeeding to the Registration Status of a Predecessor Firm	7/24/06
5/23/06	Proposed Rules on Periodic Reporting by Registered Public Accounting Firms	7/24/06
10/26/04	Proposed Rule on Procedures Relating to Subpoena Requests in Disciplinary Proceedings	11/29/04

INFORMATION

The initials stand for the following organizations. Exposure drafts are available online at the Web addresses below or copies may be obtained at the address in parentheses (unless otherwise indicated).

- FASB—** Financial Accounting Standards Board (Order Department, Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); www.fasb.org
- GASB—** Governmental Accounting Standards Board (Order Department, Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); www.gasb.org
- AICPA—** American Institute of CPAs (American Institute of Certified Public Accountants, 220 Leigh Farm Road, Durham, NC 27707-8110). AICPA publishes exposure drafts exclusively on the Web at www.aicpa.org. Print copies are not available.
- IASB—** International Accounting Standards Board (International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom); www.iasb.org
- IFAC—** International Federation of Accountants (International Federation of

Accountants, 545 Fifth Avenue, 14th Floor, New York, NY 10017); www.ifac.org

SEC— Securities and Exchange Commission (Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549); www.sec.gov

FASAB— Federal Accounting Standards Advisory Board (Federal Accounting Standards Advisory Board, 441 G Street, N.W., Suite 6814, Washington, DC 20548); www.fasab.gov

PCAOB— Public Company Accounting Oversight Board (Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, DC 20006-2803); www.pcaobus.org

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OFFICIAL RELEASES

SAS NO. 115...SSAE NO. 15

SAS NO. 115

Statement on Auditing Standards No. 115, Communicating Internal Control Related Matters Identified in an Audit

APPLICABILITY

1. This Statement on Auditing Standards (SAS) establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It is applicable whenever an auditor expresses or disclaims an opinion on financial statements. In particular, this SAS

- defines the terms *deficiency in internal control*, *significant deficiency*, and *material weakness*.
- provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements.
- requires the auditor to communicate, in writing, to management and those charged with governance,¹ significant deficiencies and material weaknesses identified in an audit.

2. This SAS is not applicable if the auditor is engaged to report on the effectiveness of an entity's internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1).

INTRODUCTION

3. Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting. In this SAS, the term *financial reporting* relates to the preparation of reliable financial statements that are fairly presented in con-

formity with generally accepted accounting principles (GAAP).² The design and formality of an entity's internal control will vary depending on the entity's size, the industry in which it operates, its culture, and management's philosophy.

4. In an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control^{3,4} or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of deficiencies in internal control while obtaining an understanding of the entity and its environment, including its internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risks, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of deficiencies in internal control varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

DEFINITIONS

5. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A deficiency in *design* exists when

- a control necessary to meet the control objective is missing; or
- an existing control is not properly designed so that, even if the control operates as

designed, the control objective would not be met.

A deficiency in *operation* exists when

- a properly designed control does not operate as designed; or
- the person performing the control does not possess the necessary authority or competence to perform the control effectively.

6. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility⁵ that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

7. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

EVALUATING DEFICIENCIES IDENTIFIED AS PART OF THE AUDIT

8. The auditor should evaluate the severity of each deficiency in internal control⁶ identified during the audit to determine whether the deficiency, individually or in combination, is a significant deficiency or a material weakness. The severity of a deficiency depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure.

The severity of a deficiency does not depend on whether a misstatement actually occurred.

9. Factors that affect the magnitude of a misstatement that might result from a deficiency or deficiencies include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency

10. In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas

5. In this SAS, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable* as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

6. Hereinafter in this SAS, the term *deficiency in internal control* is referred to as a *deficiency* or *deficiencies*.

1. The term *those charged with governance* is defined in paragraph .03 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), as "the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards."

2. Reference to generally accepted accounting principles includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles, as that term is defined in paragraph .04 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), as amended.

3. Hereinafter in this Statement on Auditing Standards (SAS), the term *internal control* means internal control over financial reporting.

4. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), contains a detailed discussion of internal control and identifies the following five interrelated components of internal control: (a) the control environment, (b) the entity's risk assessment, (c) information and communication systems, (d) control activities, and (e) monitoring.

understatements could be larger.

11. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls
- The interaction among the deficiencies
- The possible future consequences of the deficiency

12. The evaluation of whether a deficiency presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

13. Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a significant deficiency or a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a significant deficiency or a material weakness.

14. When performing substantive procedures or tests of the operating effectiveness of controls, the auditor may obtain evidence that a control does not operate effectively; for example, by identifying a misstatement that was not prevented, or detected and corrected by the control. Management may inform the auditor, or the auditor may otherwise become aware, of the existence of compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency or a material weakness. In these circumstances, although the auditor is not required to consider the effects of compensating controls for purposes of this SAS, the auditor may consider the effects of compensating controls related to a deficiency in operation provided the auditor has tested the compensating controls for operating effectiveness as part of the financial statement audit. Compensating controls can limit the severity of the deficiency, but do not eliminate the deficiency.

15. Indicators of material weaknesses in internal control include

- identification of fraud, whether or not material, on the part of senior management;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;

- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

16. If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

COMMUNICATION—FORM, CONTENT, AND TIMING

17. Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this SAS should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

18. The written communication referred to in paragraph 17 is best made by the report release date,⁷ which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date.

19. For some matters, early communication to management or those charged with governance may be important because of their relative significance and the urgency for corrective follow-up action. Accordingly, the auditor may decide to communicate certain matters during the audit. These matters need not be communicated in writing during the audit, but significant deficiencies and material weaknesses should ultimately be included in a written communication in accordance with paragraphs 17–18, even if such significant deficiencies or material weaknesses were remediated during the audit.

20. The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept the risk associated with the deficiencies because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. The auditor's responsibility to communicate significant deficiencies and material weaknesses exists regardless of management's decisions.

21. Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal

control. For example, the auditor may communicate

- matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls.
- deficiencies that are not significant deficiencies or material weaknesses.

If other matters are communicated orally, the auditor should document the communication.

22. The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should

- include a statement that indicates the purpose of the auditor's consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control.
- include a statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- include a statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- include the definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- identify the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- include a statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

23. The auditor may include additional statements in the communication regarding the general inherent limitations of internal control, including the possibility of management override of controls, or the specific nature and extent of the auditor's consideration of internal control during the audit.

24. Management or those charged with governance may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements to submit to governmental authorities. Exhibit A includes an illustrative communication when the auditor has not identified any material weaknesses and decides, or has been requested, to advise management and those charged with governance that no material weaknesses were identified.

25. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

26. Management may wish to, or may be required by a regulator to, prepare a written response to the auditor's communication regarding significant

(continued on page 114)

7. See paragraph .23 of AU section 339, *Audit Documentation* (AICPA, Professional Standards, vol. 1), for additional guidance related to the report release date.

deficiencies or material weaknesses identified during the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor may add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph:

ABC Company's written response to the significant deficiencies [and material weaknesses] identified in our audit was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

EFFECTIVE DATE

27. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

28.

EXHIBIT A-ILLUSTRATIVE WRITTEN COMMUNICATIONS

1. The following is an illustrative written communication encompassing the requirements in paragraph 22 of this Statement on Auditing Standards (SAS):

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses [and other deficiencies that we consider to be significant deficiencies].

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to

prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. [We consider the following deficiencies in the Company's internal control to be material weaknesses:]

[Describe the material weaknesses that were identified.]

[A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Company's internal control to be significant deficiencies:]

[Describe the significant deficiencies that were identified.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

2. The following is an illustrative written communication indicating that no material weaknesses were identified during the audit.

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, [iden-

tify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

If one or more significant deficiencies have been identified, the auditor may add the following sentence to the third paragraph of the communication:

However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date]. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

29.

EXHIBIT B-EXAMPLES OF CIRCUMSTANCES THAT MAY BE DEFICIENCIES, SIGNIFICANT DEFICIENCIES, OR MATERIAL WEAKNESSES

Paragraph 15 of this Statement on Auditing Standards identifies indicators of material weaknesses in internal control. The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses:

Deficiencies in the Design of Controls

- Inadequate design of controls over the preparation of the financial statements being audited.
- Inadequate design of controls over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization; for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.

- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions; for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by entity personnel to the auditor (an indicator of fraud).
- Management override of controls.

- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

This statement, Communicating Internal Control Related Matters Identified in an Audit, was unanimously adopted by the assenting votes of the 19 members of the board.

Auditing Standards Board (2007–2008)

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Internal Control Task Force

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The AICPA gratefully acknowledges the work of Maria C. Manasses in the development of this Statement on Auditing Standards.

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<i>Vice President</i>	<i>Technical Manager</i>
<i>Professional Standards</i>	<i>Audit and Attest Standards and Services</i>

Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 202), of the Institute's Code of Professional Conduct requires compliance with these standards in an audit of a nonissuer.*

SSAE NO. 15

Statement on Standards for Attestation Engagements No. 15, An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements

APPLICABILITY

1. This Statement on Standards for Attestation Engagements (SSAE) establishes requirements and provides guidance that applies when a practitioner¹ is engaged to perform an examination of the design and operating effectiveness of an entity's internal control over financial reporting (*examination of internal control*)² that is integrated with an audit of financial statements (*integrated audit*).³
2. Ordinarily, the auditor will be engaged to examine the effectiveness of the entity's internal control over financial reporting (hereinafter referred to as *internal control*) as of the end of the entity's fiscal year; however, management may select a different date. If the auditor is engaged to examine the effectiveness of an entity's internal control at a date different from the end of the entity's fiscal year, the examination should, nevertheless, be integrated with a financial statement audit (see paragraphs 18–19).
3. An auditor may be engaged to examine the effectiveness of an entity's internal control for a period of time. In that circumstance, the guidance in this SSAE should be modified accordingly, and the examination of internal control should be integrated with an audit of financial statements that covers the same period of time.
4. This SSAE does not provide guidance for the following:
 - a. Engagements to examine the suitability of design of an entity's internal control. Such engagements may be developed and performed under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1).⁴
 - b. Engagements to examine controls over the effectiveness and efficiency of operations. Such engagements may be developed and performed under AT section 101.
 - c. Engagements to examine controls over compliance with laws and regulations. See AT section 601, *Compliance Attestation* (AICPA,

1. In this Statement on Standards for Attestation Engagements (SSAE), the *practitioner* is referred to as the *auditor* because the examination of internal control is integrated with an audit of financial statements, and an examination provides the same level of assurance as an audit.

2. In this SSAE, the phrase *examination of internal control* means an engagement to report directly on internal control or on management's assertion thereon. The performance guidance in this SSAE applies equally to either reporting alternative.

3. Certain regulatory bodies require the examination of internal control and the audit of the financial statements to be performed by the same auditor. There are difficulties inherent in integrating the examination of internal control and the audit of the financial statements to meet the requirements of this SSAE when the audit of the financial statements is performed by a different auditor. In such circumstances, the requirements of this SSAE, nevertheless, apply.

4. Although this SSAE does not apply when an auditor is engaged to examine the suitability of design of an entity's internal control, it may be useful in planning and performing such engagements.

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- Professional Standards*, vol. 1).
- d. Engagements to report on controls at a service organization. See AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).
 - e. Engagements to perform agreed-upon procedures on controls. See AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1).
5. The auditor may be requested to perform certain nonattest services related to the entity's internal control in addition to the examination of internal control. The auditor should determine whether to perform such nonattest services after considering relevant ethical requirements.
6. An auditor should not accept an engagement to review an entity's internal control or a written assertion thereon.

DEFINITIONS AND UNDERLYING CONCEPTS

7. For purposes of this SSAE, the terms listed below are defined as follows:

Control objective. The aim or purpose of specified controls. Control objectives ordinarily address the risks that the controls are intended to mitigate. In the context of internal control, a control objective generally relates to a relevant assertion for a significant account or disclosure and addresses the risk that the controls in a specific area will not provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented, or detected and corrected on a timely basis.

Deficiency. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Detective control. A control that has the objective of detecting and correcting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

Financial statements and related disclosures. An entity's financial statements and notes to the financial statements as presented in accordance with the applicable financial reporting framework.⁵ References to financial statements and related disclosures do not extend to the preparation of other finan-

cial information presented outside an entity's basic financial statements and notes.

Internal control over financial reporting.⁶ A process effected by those charged with governance,⁷ management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework and includes those policies and procedures that⁸

- i. pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity;
- ii. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the applicable financial reporting framework, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and
- iii. provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Internal control has inherent limitations. Internal control is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented, or detected and corrected on a timely basis by

internal control. However, these inherent limitations are known aspects of the financial reporting process.

Management's assertion. Management's conclusion about the effectiveness of the entity's internal control that is included in management's report on internal control.

Material weakness. A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility⁹ that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Preventive control. A control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.

Relevant assertion. A financial statement assertion¹⁰ that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of controls.

Significant account or disclosure. An account balance or disclosure that has a reasonable possibility that it could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account balance or disclosure is a significant account or disclosure is made without regard to the effect of controls.

Significant deficiency. A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

8. Effective internal control provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. If one or more material weaknesses exist, the entity's internal control cannot be considered effective.

9. The auditor's objective in an examination of internal control is to form an opinion on the effectiveness of the entity's internal control. Because an entity's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor should plan and perform the examination to obtain sufficient appropriate evidence to obtain reasonable assurance¹¹ about whether material weaknesses exist

5. The applicable financial reporting framework is the accounting framework used for preparing and presenting the financial statements, such as generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board, or an other comprehensive basis of accounting (OCBOA), as described in AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1).

6. For insured depository institutions (IDIs) subject to the internal control reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), internal control includes controls over the preparation of the IDI's financial statements and related disclosures in accordance with GAAP and with the instructions to the *Consolidated Financial Statements for Bank Holding Companies*. Internal control also includes controls over the preparation of the IDI's financial statements and related disclosures in accordance with GAAP and controls over the preparation of schedules equivalent to the basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (call report instructions) or with the Office of Thrift Supervision Instructions for Thrift Financial Reports (TFR instructions).

7. The term *those charged with governance* is defined in paragraph .03 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), as "... the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards."

8. The auditor's procedures performed as part of the integrated audit are not part of an entity's internal control.

9. In this SSAE, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are used in Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.

10. The financial statement assertions are described in AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). The auditor may use the financial statement assertions as they are described in AU section 326 or express them differently, provided aspects described in AU section 326 have been covered, and the auditor has selected and tested controls over the identified risks in each significant account and disclosure.

as of the date specified in management's assertion. A material weakness in internal control may exist even when financial statements are not materially misstated. The auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

10. An auditor engaged to perform an examination of internal control should comply with the general, fieldwork, and reporting standards in AT section 101, and the specific performance and reporting requirements set forth in this SSAE. In this SSAE, the subject matter is the effectiveness of internal control, and the responsible party usually is management of the entity. Accordingly, the term *management* is used in this SSAE to refer to the responsible party.

11. The auditor should use the same suitable and available control criteria¹² to perform his or her examination of internal control as management uses for its evaluation of the effectiveness of the entity's internal control.

12. An auditor may perform an examination of internal control only if the following conditions are met:

- a. Management accepts responsibility for the effectiveness of the entity's internal control.
- b. Management evaluates the effectiveness of the entity's internal control using suitable and available criteria.
- c. Management supports its assertion about the effectiveness of the entity's internal control with sufficient appropriate evidence (see discussion beginning at paragraph 14).
- d. Management provides its assertion about the effectiveness of the entity's internal control in a report that accompanies the auditor's report (see paragraph 95).

13. Management's refusal to furnish a written assertion should cause the auditor to withdraw from the engagement. However, if law or regulation does not allow the auditor to withdraw from the engagement and management refuses to furnish a written assertion, the auditor should disclaim an opinion on internal control.¹³

Evidence Supporting Management's Assertion

14. Management is responsible for identifying and

11. The high, but not absolute, level of assurance that is intended to be obtained by the auditor is expressed in the auditor's report as obtaining reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects as of the date specified in management's assertion. See paragraph .54 of AT section 101, *Attest Engagements*, and AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1).
 12. According to paragraph .23 of AT section 101 "[t]he third general attestation standard is—The auditor must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users." The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) report *Internal Control—Integrated Framework* provides suitable and available criteria against which management may evaluate and report on the effectiveness of the entity's internal control. *Internal Control—Integrated Framework* describes an entity's internal control as consisting of five components: control environment, risk assessment, control activities, information and communication, and monitoring. See AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), for a discussion of these components. If management selects another framework, see paragraphs .23–.34 of AT section 101 for guidance on evaluating the suitability and availability of criteria.
 13. See paragraphs 117–121 when disclaiming an opinion, including the requirement for the auditor's report to include a description of any material weaknesses identified.

documenting the controls and the control objectives that they were designed to achieve. Such documentation serves as a basis for management's assertion. Documentation of the design of controls, including changes to those controls, is evidence that controls upon which management's assertion is based are

- identified.
- capable of being communicated to those responsible for their performance.
- capable of being monitored and evaluated by the entity.

15. Management's documentation may take various forms, for example, entity policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or completed questionnaires. No one, particular form of documentation is prescribed, and the extent of documentation may vary depending upon the size and complexity of the entity and the entity's monitoring activities.

16. Management's monitoring activities also may provide evidence of the design and operating effectiveness of internal control in support of management's assertion. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis, identifying and reporting deficiencies to appropriate individuals within the organization, and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.

17. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The greater the degree and effectiveness of ongoing monitoring, the less need for separate evaluations. Usually, some combination of ongoing monitoring and separate evaluations will ensure that internal control maintains its effectiveness over time.

INTEGRATING THE EXAMINATION WITH THE FINANCIAL STATEMENT AUDIT

18. The examination of internal control should be integrated with an audit of financial statements. Although the objectives of the engagements are not the same, the auditor should plan and perform the integrated audit to achieve the objectives of both engagements simultaneously. The auditor should design tests of controls

- to obtain sufficient appropriate evidence to support the auditor's opinion on internal control as of the period-end; and
- to obtain sufficient appropriate evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

19. The date specified in management's assertion (the as-of date of the examination) should correspond to the balance sheet date (or period ending date) of the period covered by the financial statements (see paragraph 2).

20. Obtaining sufficient appropriate evidence to support the operating effectiveness of controls for

purposes of the financial statement audit ordinarily allows the auditor to modify the substantive procedures that otherwise would have been necessary to opine on the financial statements. (Integration is described further beginning at paragraph 159.)

21. In some circumstances, particularly in some audits of smaller, less complex entities, the auditor might choose not to test the operating effectiveness of controls for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the entity's internal control is effective as of period-end. The auditor should consider the results of the financial statement auditing procedures in determining his or her risk assessments and the testing necessary to conclude on the operating effectiveness of a control.

PLANNING THE EXAMINATION

22. The auditor should plan the examination of internal control. Evaluating whether the following matters are important to the entity's financial statements and internal control and, if so, how they may affect the auditor's procedures, may assist the auditor in planning the examination:

- Knowledge of the entity's internal control obtained during other engagements performed by the auditor or, if applicable, during a review of a predecessor auditor's working papers
- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, and capital structure
- The extent of recent changes, if any, in the entity, its operations, or its internal control
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses
- Deficiencies previously communicated to those charged with governance or management
- Legal or regulatory matters of which the entity is aware
- The type and extent of available evidence related to the effectiveness of the entity's internal control
- Preliminary judgments about the effectiveness of internal control
- Public information about the entity relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the entity's internal control
- Knowledge about risks related to the entity evaluated as part of the auditor's client acceptance and retention evaluation
- The relative complexity of the entity's operations

Role of Risk Assessment

23. Risk assessment underlies the entire examination
 (continued on page 118)

tion process described by this SSAE, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control. When performing an examination of internal control that is integrated with an audit of financial statements, the same risk assessment process supports both engagements.¹⁴

24. The auditor should focus more attention on the areas of highest risk. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the entity's internal control and the amount of attention that would be devoted to that area. In addition, an entity's internal control is less likely to prevent, or detect and correct a misstatement caused by fraud than a misstatement caused by error. It is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

Scaling the Examination

25. The size and complexity of the entity, its business processes, and business units may affect the way in which the entity achieves many of its control objectives. Many smaller entities have less complex operations. Additionally, some larger, complex entities may have less complex units or processes. Factors that might indicate less complex operations include fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control. Accordingly, a smaller, less complex entity, or even a larger, less complex entity might achieve its control objectives differently from a more complex entity.

26. The size and complexity of the organization, its business processes, and business units also may affect the auditor's risk assessment and the determination of the necessary procedures and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to examinations of all entities.

Addressing the Risk of Fraud

27. When planning and performing the examination of internal control, the auditor should incorporate the results of the fraud risk assessment performed in the financial statement audit. As part of identifying and testing entity-level controls, as discussed beginning at paragraph 37, and selecting other controls to test, as discussed beginning at paragraph 54, the auditor should evaluate whether the entity's controls sufficiently address identified risks of material misstatement due to fraud¹⁵ and the risk of management override of other controls. Controls that might address these risks include

- controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- controls over journal entries and adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant management estimates; and
- controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

28. If the auditor identifies deficiencies in controls designed to prevent, or detect and correct misstatements caused by fraud during the examination of internal control, he or she should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), paragraphs .44–.45.

Using the Work of Others

29. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself.

30. AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), applies in an integrated audit. For purposes of the examination of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, entity personnel (in addition to internal auditors), and third parties working under the direction of management or those charged with governance that provide evidence about the effectiveness of internal control. In an integrated audit, the auditor also may use this work to obtain evidence supporting the assessment of control risk for purposes of the financial statement audit.

31. The auditor should obtain an understanding of the work of others sufficient to identify those activities related to the effectiveness of internal control that are relevant to planning the examination of internal control. The extent of the procedures necessary to obtain this understanding will vary, depending on the nature of those activities.

32. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09–.11 of AU section 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

33. For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding, knowledge, and skills that

enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work that the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work that the auditor plans to use. The effect of the work of others on the auditor's work also depends on the relationship between the risk associated with a control and the competence and objectivity of those who performed the work. As the risk associated with a control decreases, the necessary level of competence and objectivity decreases as well. In higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

34. The extent to which the auditor may use the work of others also depends, in part, on the risk associated with the control being tested (see paragraph 62). As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

35. In planning and performing the examination of internal control, the auditor should use the same materiality used in planning and performing the audit of the entity's financial statements.¹⁶

USING A TOP-DOWN APPROACH

36. The auditor should use a top-down approach¹⁷ to the examination of internal control to select the controls to test. A top-down approach involves

- beginning at the financial statement level;
- using the auditor's understanding of the overall risks to internal control;
- focusing on entity-level controls;
- working down to significant accounts and disclosures and their relevant assertions;
- directing attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures;
- verifying the auditor's understanding of the risks in the entity's processes; and
- selecting controls for testing that sufficiently address the assessed risk of material misstatement to each relevant assertion.

Identifying Entity-Level Controls

37. The auditor should test those entity-level controls that are important to his or her conclusion about whether the entity has effective internal control. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that

14. The risk assessment procedures performed in connection with a financial statement audit are described in AU section 314.

15. See paragraphs .19–.42 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), regarding identifying risks that may result in material misstatement due to fraud.

16. See AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), which provides additional explanation of materiality.

17. The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the examination procedures.

he or she otherwise would have performed on other controls.

38. Entity-level controls include

- controls related to the control environment;
- controls over management override;¹⁸
- the entity's risk assessment process;
- centralized processing and controls, including shared service environments;
- controls to monitor results of operations;
- controls to monitor other controls, including activities of the internal audit function, those charged with governance, and self-assessment programs;
- controls over the period-end financial reporting process; and
- programs and controls that address significant business control and risk management practices.

39. Entity-level controls vary in nature and precision:

- Some entity-level controls, such as certain control environment controls, have an important but indirect effect on the likelihood that a misstatement will be prevented, or detected and corrected on a timely basis. These controls might affect the other controls that the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that material misstatements to a relevant assertion will be prevented, or detected and corrected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent, or detect and correct on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of material misstatement, the auditor need not test additional controls relating to that risk.

Control Environment

40. Because of its importance to effective internal control, the auditor should evaluate the control environment at the entity. When evaluating the control environment, the auditor should apply paragraphs .67–.75 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional*

18. Controls over management override are important to effective internal control for all entities and may be particularly important at smaller, less complex entities because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller, less complex entities, the controls that address the risk of management override might be different from those at a larger entity. For example, a smaller, less complex entity might rely on more detailed oversight by those charged with governance that focuses on the risk of management override.

Standards, vol. 1). As part of evaluating the control environment, the auditor should assess

- whether management's philosophy and operating style promote effective internal control;
- whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- whether those charged with governance understand and exercise oversight responsibility over financial reporting and internal control.

Period-End Financial Reporting Process

41. Because of its importance to financial reporting and to the integrated audit, the auditor should evaluate the period-end financial reporting process.¹⁹ The period-end financial reporting process includes the following:

- Procedures used to enter transaction totals into the general ledger
- Procedures related to the selection and application of accounting policies
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger
- Procedures used to record recurring and nonrecurring adjustments to the financial statements
- Procedures for preparing financial statements and related disclosures

42. As part of evaluating the period-end financial reporting process, the auditor should assess

- the inputs, procedures performed, and outputs of the processes the entity uses to produce its financial statements;
- the extent of IT involvement in the period-end financial reporting process;
- who participates from management;
- the locations involved in the period-end financial reporting process;
- the types of adjusting and consolidating entries; and
- the nature and extent of the oversight of the process by management and those charged with governance.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

43. The auditor should identify significant accounts and disclosures and their relevant assertions. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include

- size and composition of the account;
- susceptibility to misstatement due to errors or fraud;

19. Because the annual period-end financial reporting process normally occurs after the as-of date of management's assertion, those controls usually cannot be tested until after the as-of date.

- volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- nature of the account, class of transactions, or disclosure;
- accounting and reporting complexities associated with the account, class of transactions, or disclosure;
- exposure to losses in the account;
- possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- existence of related party transactions in the account; and
- changes from the prior period in the account, class of transactions, or disclosure characteristics.

44. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

45. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the examination of internal control as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same in an integrated audit.²⁰

46. The components of a potential significant account or disclosure might be subject to significantly different risks. If so, different controls might be necessary to adequately address those risks.

47. When an entity has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Understanding Likely Sources of Misstatement

48. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives:

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded
- Identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise that, individually or in combination with other misstatements, would be material (for example, points at which information is initiated, transferred, or otherwise modified)
- Identify the controls that management has implemented to address these potential misstatements

20. The risk assessment procedures performed in connection with a financial statement audit are described in AU section 314.

(continued on page 122)

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Adapted from *Smart Risk Management: A Guide to Identifying and Reducing Everyday Business Risks*, by Ron Rael, CPA

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Internal control components are deficient as a result of the following:

- ☐ Am I able to sleep at night without worrying about risk in my organization?
- ☐ Do I have a clear understanding of firm-wide risk, the organization's key areas of vulnerability, and our ability to recover quickly?
- ☐ Am I confident that an accountable executive is addressing each risk, large and small?
- ☐ Is there a process or function within my organization that is responsible for assessing, measuring, and monitoring risk?
- ☐ Have we created a realistic balance between innovation and protection?
- ☐ Do our cultural norms help us ensure that all costly risk is identified before we take it?
- ☐ Does my organization have an operational system or process for evaluating risk?
- ☐ Do I have complete assurance that financial and operational controls are being used as designed?
- ☐ Does your organization have a thorough and appropriate system with timely reports that use checks or balances on innovation, fraud prevention, and risks faced?
- ☐ Do I have assurance that financial and other information is reported correctly?
- ☐ Are our processes for risk assessment, management control, and governance being evaluated and reviewed for both efficiency and effectiveness on an ongoing basis?
- ☐ Is there an emphasis and supporting process within my organization for aiding productivity and for improving operations?

- ☐ Are my organization's stakeholders provided with reliable assurances that their investment is protected by ethical and sustainable means?
- ☐ If I were not part of the organization firm's management or the board, would I be comfortable with the assurances provided to me (as a stakeholder or investor)?
- ☐ Do we have a specific written recovery plan in the event that we suffer from a major risk failure?

Adapted from *Smart Risk Management: A Guide to Identifying and Reducing Everyday Business Risks*, by Ron Rael, CPA, published by AICPA. To order product #029884 please go to www.cpa2biz.com or call toll free 1-888-777-7077.

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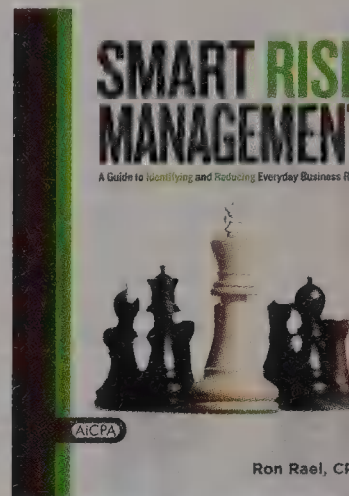
Answer Key

13-15 checked — Congratulations! You have a high Risk IQ! Keep doing what you are doing and improve those areas you did not check off.

10-12 checked — Good job! You are effectively managing your risk, but are still vulnerable in many areas. Get started on removing those weaknesses to

7-9 checked — Scammers love you! You have so many areas of vulnerability that fixing these vulnerabilities will be like trying to empty a full bathtub with a teaspoon. Get cracking!

0-6 checked — Sharpen your resume! Your company will be out of business within two years. Ouch.



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- Identify the controls that management has implemented over the prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could result in a material misstatement of the financial statements

49. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 48 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU section 322.

50. The auditor also should understand how IT affects the entity's flow of transactions. The auditor should apply paragraphs .57–.63 of AU section 314, which discuss the effect of IT on internal control and the risks to assess.

51. The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify likely sources of misstatement and the controls to test, as well as to assess risk and allocate audit effort.

Performing Walkthroughs

52. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 48. A walkthrough involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial records, using the same documents and IT that entity personnel use. Walkthrough procedures may include a combination of inquiry, observation, inspection of relevant documentation, recalculation, and control reperformance.

53. A walkthrough includes questioning the entity's personnel about their understanding of what is required by the entity's prescribed procedures and controls at the points at which important processing procedures occur. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough may provide an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

54. The auditor should test those controls that are important to the auditor's conclusion about whether the entity's controls sufficiently address the assessed risk of material misstatement to each relevant assertion.

55. There might be more than one control that addresses the assessed risk of material misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of material misstatement to more than one relevant assertion. It may not be necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is, itself, a con-

trol objective.

56. The decision concerning whether a control would be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of material misstatement to a given relevant assertion rather than on how the control is labeled (for example, entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control).

TESTING CONTROLS

Evaluating Design Effectiveness

57. The auditor should evaluate the design effectiveness of controls by determining whether the entity's controls, if they are applied as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the entity's control objectives, and can effectively prevent, or detect and correct misstatements caused by errors or fraud that could result in material misstatements in the financial statements.

58. A smaller, less complex entity might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex entity might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the entity to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

59. Procedures performed to evaluate design effectiveness may include a mix of inquiry of appropriate personnel, observation of the entity's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

60. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.²¹

61. Procedures performed to test operating effectiveness may include a mix of inquiry of appropriate personnel, observation of the entity's operations, inspection of relevant documentation, recalculation, and reperformance of the control.

Relationship of Risk to the Evidence to Be Obtained

62. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not

be effective and, if not effective, the risk that a material weakness exists. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

63. Although the auditor should obtain evidence about the effectiveness of controls for each relevant assertion, he or she is not responsible for obtaining sufficient appropriate evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the entity's internal control overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

64. Factors that affect the risk associated with a control may include

- the nature and materiality of misstatements that the control is intended to prevent, or detect and correct;
- the inherent risk associated with the related account(s) and assertion(s);
- whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- whether the account has a history of errors;
- the effectiveness of entity-level controls, especially controls that monitor other controls;
- the nature of the control and the frequency with which it operates;
- the degree to which the control relies on the effectiveness of other controls (for example, the control environment or IT general controls);
- the competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- whether the control relies on performance by an individual or is automated (that is, an automated control would generally be expected to be lower risk if relevant IT general controls are effective);²² and
- the complexity of the control and the significance of the judgments that would be made in connection with its operation.²³

65. When the auditor identifies control deviations, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

22. A smaller, less complex entity or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of IT controls might focus on the application controls built into the prepackaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

23. Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

66. Because effective internal control cannot and does not provide absolute assurance of achieving the entity's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

67. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient appropriate evidence in relation to the risk associated with the control.

68. Walkthroughs may include a combination of inquiry of appropriate personnel, observation of the entity's operations, inspection of relevant documentation, recalculation, and reperformance of the control and might provide sufficient appropriate evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough, and the results of those procedures.

Nature of Tests of Controls

69. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, recalculation, and reperformance of a control. Inquiry alone, however, does not provide sufficient appropriate evidence to support a conclusion about the effectiveness of a control.

70. The nature of the tests of effectiveness that will provide sufficient appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

71. A smaller, less complex entity or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, recalculation, or reperformance of certain controls, might provide sufficient appropriate evidence about whether the control is effective.

Timing and Extent of Tests of Controls

72. Testing controls over a longer period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assertion provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient appropriate evidence of operating effectiveness.

73. Prior to the date specified in management's assertion, management might implement changes to the entity's controls to make them more effective

or efficient or to address deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment in the financial statement audit, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (Integration is discussed beginning at paragraph 159.)

74. The more extensively a control is tested, the greater the evidence obtained from that test.

Rollforward Procedures

75. When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

76. The additional evidence that is necessary to update the results of testing from an interim date to the entity's period-end depends on the following factors:²⁴

- The specific control tested prior to the as-of date, including the risks associated with the control, the nature of the control, and the results of those tests
- The sufficiency of the evidence of operating effectiveness obtained at an interim date
- The length of the remaining period
- The possibility that there have been any significant changes in internal control subsequent to the interim date

Special Considerations for Subsequent Years' Examinations

77. In subsequent years' examinations, the auditor should incorporate knowledge obtained during past examinations he or she performed of the entity's internal control into the decision making process for determining the nature, timing, and extent of testing necessary. This decision making process is described in paragraphs 62–76.

78. Factors that affect the risk associated with a control in subsequent years' examinations include those in paragraph 64 and the following:

- The nature, timing, and extent of procedures performed in previous examinations
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous examination

79. After taking into account the risk factors identified in paragraphs 64 and 78, the additional infor-

mation available in subsequent years' examinations might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

80. The auditor also may use a benchmarking strategy for automated application controls in subsequent years' examinations. Benchmarking is described further beginning at paragraph 153.

81. In addition, the auditor should vary the nature, timing, and extent of testing of controls from period to period to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

EVALUATING IDENTIFIED DEFICIENCIES

82. The auditor should evaluate the severity of each deficiency to determine whether the deficiency, individually or in combination, is a material weakness as of the date of management's assertion.

83. The severity of a deficiency depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure.

The severity of a deficiency does not depend on whether a misstatement actually occurred.

84. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency

85. In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated is generally the recorded amount, whereas understatements could be larger.

86. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls
- The interaction among the deficiencies
- The possible future consequences of the deficiency

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24. In some circumstances, such as when evaluation of these factors indicates a low risk that the controls are no longer effective during the rollforward period, inquiry alone might be sufficient as a rollforward procedure.

87. The evaluation of whether a deficiency presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

88. Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

89. Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control also may collectively result in a significant deficiency.

90. A compensating control can limit the severity of a deficiency and prevent it from being a material weakness. Although compensating controls can mitigate the effects of a deficiency, they do not eliminate the deficiency. The auditor should evaluate the effect of compensating controls when determining whether a deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent, or detect and correct a material misstatement. The auditor should test the operating effectiveness of compensating controls.

Indicators of Material Weaknesses

91. Indicators of material weaknesses in internal control include

- identification of fraud, whether or not material, on the part of senior management;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;
- identification by the auditor of a material misstatement of financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

92. If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, he or she should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

CONCLUDING PROCEDURES

Forming an Opinion

93. The auditor should form an opinion on the effectiveness of internal control by evaluating evidence obtained from all sources, including the audi-

tor's testing of controls, misstatements detected during the financial statement audit, and any identified deficiencies.

94. As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control and evaluate deficiencies identified in those reports.

95. After forming an opinion on the effectiveness of the entity's internal control, the auditor should evaluate management's report to determine whether it appropriately contains the following:

- A statement regarding management's responsibility for internal control
- A description of the subject matter of the examination (for example, controls over the preparation of the entity's financial statements in accordance with generally accepted accounting principles [GAAP])
- An identification of the criteria against which internal control is measured (for example, criteria established in the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control—Integrated Framework*)
- Management's assertion about the effectiveness of internal control
- A description of the material weaknesses, if any
- The date as of which management's assertion is made

96. If the auditor determines that any required element of management's report is incomplete or improperly presented, the auditor should request management to revise its report. If management does not revise its report, the auditor should apply paragraph 116. If management refuses to furnish a report, the auditor should apply paragraph 13.

Obtaining Written Representations

97. In an examination of internal control, the auditor should obtain written representations from management

- a. acknowledging management's responsibility for establishing and maintaining effective internal control;
- b. stating that management has performed an evaluation of the effectiveness of the entity's internal control and specifying the control criteria;
- c. stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assertion;
- d. stating management's assertion about the effectiveness of the entity's internal control based on the control criteria as of a specified date;
- e. stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control;

f. describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's internal control;

g. stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during previous engagements pursuant to paragraph 100 have been resolved and specifically identifying any that have not; and

h. stating whether there were, subsequent to the date being reported on, any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

98. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination.²⁵ The auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, such as those obtained in the audit of the entity's financial statements.

99. The auditor should apply AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), as it relates to matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

100. Deficiencies identified during the integrated audit that, upon evaluation, are considered significant deficiencies or material weaknesses should be communicated, in writing, to management and those charged with governance as a part of each integrated audit, including significant deficiencies and material weaknesses that were previously communicated to management and those charged with governance and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

101. If the auditor concludes that the oversight of the entity's financial reporting and internal control by the audit committee (or similar subgroups with different names) is ineffective, the auditor should communicate that conclusion, in writing, to the board of directors or other similar governing body if one exists.

102. The written communications referred to in paragraphs 100–101 should be made by the report release date,²⁶ which is the date the auditor grants

25. See paragraph 117 when the scope of the engagement has been restricted.

26. See paragraph .23 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), for additional guidance related to the report release date.

the entity permission to use the auditor's report. For a governmental entity, the auditor is not required to make the written communications by the report release date, if such written communications would be publicly available prior to management's report on internal control, the entity's financial statements, and the auditor's report thereon. In that circumstance, the written communications should be made as soon as practicable, but no later than 60 days following the report release date.

103. Because of the importance of timely communication, the auditor may choose to communicate significant matters during the course of the integrated audit. If the communication is made during the integrated audit, the form of interim communication would be affected by the relative significance of the identified deficiencies and the urgency for corrective follow-up action. Such early communication is not required to be in writing. However, regardless of how the early communication is delivered, the auditor should communicate all significant deficiencies and material weaknesses in writing to management and those charged with governance in accordance with paragraphs 100–102, even if the significant deficiencies or material weaknesses were remediated during the examination.

104. The auditor also should communicate to management, in writing, all deficiencies (those deficiencies that are not material weaknesses or significant deficiencies) identified during the integrated audit on a timely basis, but no later than 60 days following the report release date, and inform those charged with governance when such a communication was made. In making the written communication referred to in this paragraph, the auditor is not required to communicate those deficiencies that are not material weaknesses or significant deficiencies that were included in previous written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

105. The auditor is not required to perform procedures that are sufficient to identify all deficiencies; rather, the auditor communicates deficiencies of which he or she is aware.

106. Because the integrated audit does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were identified during the integrated audit. Also, because the auditor's objective in an examination of internal control is to form an opinion on the effectiveness of the entity's internal control, the auditor should not issue a report indicating that no material weaknesses were identified during the integrated audit.

REPORTING ON INTERNAL CONTROL

107. The auditor's report on the examination of internal control should include the following elements:²⁷

- a. A title that includes the word *independent*

- b. A statement that management is responsible for maintaining effective internal control and for evaluating the effectiveness of internal control
- c. An identification of management's assertion on internal control that accompanies the auditor's report, including a reference to management's report
- d. A statement that the auditor's responsibility is to express an opinion on the entity's internal control (or on management's assertion)²⁸ based on his or her examination²⁹
- e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants
- f. A statement that such standards require that the auditor plan and perform the examination to obtain reasonable assurance about whether effective internal control was maintained in all material respects
- g. A statement that an examination includes obtaining an understanding of internal control, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considers necessary in the circumstances
- h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion
- i. A definition of internal control (the auditor should use the same description of the entity's internal control as management uses in its report)
- j. A paragraph stating that, because of inherent limitations, internal control may not prevent, or detect and correct misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate
- k. The auditor's opinion on whether the entity maintained, in all material respects, effective internal control as of the specified date, based on the control criteria; or, the auditor's opinion on whether management's assertion about the effectiveness of the entity's internal control as of the specified date is fairly stated, in all material respects, based on the control criteria
- l. The manual or printed signature of the auditor's firm
- m. The date of the report

28. The auditor may report directly on the entity's internal control or on management's written assertion, except as described in paragraph 112.

29. Because the examination of internal control is integrated with the audit of the financial statements and an examination provides the same level of assurance as an audit, the auditor may refer to the examination of internal control as an audit in his or her report or other communications.

Separate or Combined Reports

108. The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on internal control) or separate reports on the entity's financial statements and on internal control.

109. If the auditor issues a separate report on internal control, he or she should add the following paragraph to the auditor's report on the financial statements:

We also have examined [or audited]³⁰ in accordance with attestation standards established by the American Institute of Certified Public Accountants, [company name]'s internal control over financial reporting as of December 31, 20X8, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinion].

The auditor also should add the following paragraph to the report on internal control:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of [company name] and our report dated [date of report, which should be the same as the date of the report on internal control] expressed [include nature of opinion].

Report Date

110. The auditor should date the report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Because the examination of internal control is integrated with the audit of the financial statements, the dates of the reports should be the same.

Adverse Opinions

111. Paragraphs 82–92 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses as of the date specified in management's assertion, the auditor should express an adverse opinion on the entity's internal control, unless there is a restriction on the scope of the engagement.³¹

112. When internal control is not effective because one or more material weaknesses exist, the auditor is prohibited from expressing an opinion on management's assertion and should report directly on the effectiveness of internal control. In addition, the auditor's report should include

- the definition of a material weakness.
- a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assertion. The auditor's report need only refer to the material weaknesses described in management's report and need not include a description

30. See footnote 29.

31. See paragraph 117 when the scope of the engagement has been restricted.

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of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report, as described in the following paragraph.

113. If one or more material weaknesses have not been included in management's report accompanying the auditor's report, the auditor's report should be modified to state that one or more material weaknesses have been identified but not included in management's report. Additionally, the auditor's report should include a description of each material weakness not included in management's report, which should provide the users of the report with specific information about the nature of each material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate, in writing, to those charged with governance that one or more material weaknesses were not disclosed or identified as a material weakness in management's report. If one or more material weaknesses have been included in management's report but the auditor concludes that the disclosure of such material weaknesses is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe each material weakness.

114. The auditor should determine the effect an adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the material weaknesses.³²

REPORT MODIFICATIONS

115. The auditor should modify his or her report if any of the following conditions exist:

- Elements of management's report are incomplete or improperly presented.
- There is a restriction on the scope of the engagement.
- The auditor decides to refer to the report of another auditor as the basis, in part, for the auditor's own report.
- There is other information contained in management's report.

Elements of Management's Report Are Incomplete or Improperly Presented

116. If the auditor determines that any required element of management's report (see paragraph 95) is incomplete or improperly presented and management does not revise its report, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about one or more material weaknesses is not fairly presented in all material respects, the

auditor should apply paragraph 113.

Scope Limitations

117. The auditor may express an opinion on the entity's internal control only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion.

118. When disclaiming an opinion because of a scope limitation, the auditor should state that he or she does not express an opinion on the effectiveness of internal control and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination of internal control (paragraph 107[d-h]); to do so might overshadow the disclaimer.

119. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that one or more material weaknesses exist, the auditor's report also should include

- the definition of a material weakness.
- a description of any material weaknesses identified in the entity's internal control. This description should address the requirements in paragraph 112 and should provide the users of the report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. The auditor also should apply the requirements in paragraph 114.

120. The auditor may issue a report disclaiming an opinion on internal control as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.³³ The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient appropriate evidence to express an opinion.

121. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination, the auditor should communicate, in writing, to management and those charged with governance that the examination of internal control cannot be satisfactorily completed.

Opinion Based, in Part, on the Report of Another Auditor

122. When another auditor has examined the internal control of one or more subsidiaries, divisions, branches, or components of the entity, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU section 543, *Part of Audit*

33. In this case, in following paragraph 110 regarding dating the report, the report date is the date that the auditor has obtained sufficient appropriate evidence to support the representations in the report.

Performed by Other Independent Auditors (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the auditor's decision of whether to serve as the principal auditor of the financial statements. The auditor should apply paragraphs .02-.03 of AU section 543 in deciding whether he or she may serve as the principal auditor of the examination of internal control.

123. When serving as the principal auditor of internal control, the auditor should decide whether to make reference in his or her report on internal control to the examination of internal control performed by the other auditor. In these circumstances, the decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on an entity's financial statements as described in AU section 543.

124. The decision about whether to make reference to another auditor in the report on the examination of internal control might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control might not make a similar reference because management's assertion ordinarily would not extend to controls at the equity method investee.³⁴

125. When the principal auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the entity's internal control, the principal auditor should refer to the report of the other auditor when describing the scope of the examination and when expressing the opinion. Whether the other auditor's opinion is expressed on management's assertion or on internal control does not affect the determination of whether the principal auditor's opinion is expressed on management's assertion or on internal control.

Management's Report Contains Additional Information

126. Management's report accompanying the auditor's report may contain information in addition to the elements described in paragraph 95 that are subject to the auditor's evaluation.³⁵ If management's report could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

127. The auditor may use the following sample language as the last paragraph of the auditor's report to disclaim an opinion on such additional

34. See paragraph 140 for further discussion of the evaluation of the controls for an equity method investment.

35. An entity may publish various documents that contain information in addition to management's report and the auditor's report on internal control. Paragraphs .91-.94 of AT section 101 provide guidance to the auditor in these circumstances. If management makes the types of disclosures described in paragraph 126 outside its report and includes them elsewhere within a document that includes the auditor's report, the auditor would not need to disclaim an opinion on such information. However, in that situation, the auditor's responsibilities are the same as those described in paragraph 128, if the auditor believes that the additional information contains a material misstatement of fact.

32. If the auditor issues a separate report on internal control in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraph 109. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

information:

We do not express an opinion or any other form of assurance on [describe additional information, such as management's cost-benefit statement].

128. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should apply the guidance in paragraphs .92-.94 of AT section 101 and take appropriate action. If the auditor concludes that a material misstatement of fact remains, the auditor should notify management and those charged with governance, in writing, of the auditor's views concerning the information. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), also may require the auditor to take additional action.

SUBSEQUENT EVENTS

129. Changes in internal control or other factors that might significantly affect internal control might occur subsequent to the date as of which internal control is being examined but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 97.

130. To obtain additional information about changes in internal control or other factors that might significantly affect the effectiveness of the entity's internal control, the auditor should inquire about and examine, for this subsequent period, the following:

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period
- Independent auditor reports (if other than the auditor's) of deficiencies
- Regulatory agency reports on the entity's internal control
- Information about the effectiveness of the entity's internal control obtained through other engagements

131. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01-.09 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), establish requirements and provide guidance on subsequent events for a financial statement audit that also may be helpful to the auditor performing an examination of internal control.

132. If, subsequent to the date as of which internal control is being examined but before the date of the auditor's report, the auditor obtains knowledge about a material weakness that existed as of the date specified in management's assertion, the auditor should report directly on internal control and issue an adverse opinion, as required by paragraph 111. The auditor should also follow paragraph 116 if management's assertion states that internal control is effective. If the auditor is unable to determine the effect of the matter on the effectiveness of the entity's internal control as of the date specified in management's assertion, the auditor should disclaim an opinion. As described in para-

graph 126, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the entity, if any.

133. The auditor may obtain knowledge about conditions that did not exist at the date specified in management's assertion but arose subsequent to that date and before the release of the auditor's report. If a subsequent event of this type has a material effect on the entity's internal control, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

134. The auditor has no responsibility to keep informed of events subsequent to the date of his or her report; however, after the release of the report on internal control, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The evaluation of such subsequent information is similar to the evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

SPECIAL TOPICS

Entities With Multiple Locations

135. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of attention devoted to the location or business unit with the degree of risk. The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the entity's consolidated financial statements.

136. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the entity's consolidated financial statements. In lower risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient appropriate evidence.

137. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform examination procedures.

138. In applying the requirement in paragraph 81 regarding special considerations for subsequent years' examinations, the auditor should vary the

nature, timing, and extent of testing of controls at locations or business units from year to year.

Special Situations

139. The scope of the examination should include entities that are acquired on or before the date of management's assertion and operations that are accounted for as discontinued operations on the date of management's assertion that are reported in accordance with the applicable financial reporting framework in the entity's financial statements.

140. For equity method investments, the scope of the examination should include controls over the reporting in accordance with the applicable financial reporting framework, in the entity's financial statements, of the entity's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The examination ordinarily would not extend to controls at the equity method investee.

141. In situations in which a regulator allows management to limit its assertion by excluding certain entities, the auditor may limit the examination in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assertion and the auditor's examination of internal control. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the regulator's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should communicate the matter to the appropriate level of management. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform those charged with governance of the matter as soon as practicable. If management and those charged with governance do not respond appropriately, the auditor should modify his or her report on the examination of internal control to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

142. AU section 324 applies to the audit of financial statements of an entity that obtains services from another organization that are part of the entity's information and communication systems. The auditor may apply the relevant concepts described in AU section 324 to the examination of internal control.

143. Paragraph .03 of AU section 324 describes the situation in which a service organization's services are part of an entity's information and communication systems. If the service organization's services are part of an entity's information and

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communication systems, as described therein, then they are part of the information and communication component of the entity's internal control. When the service organization's services are part of the entity's internal control, the auditor should consider the activities of the service organization when determining the evidence required to support his or her opinion.

144. The auditor should perform the procedures in paragraphs .07–.16 of AU section 324 with respect to the activities performed by the service organization. These procedures include

- a. obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization; and
- b. obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

145. Evidence that the controls that are relevant to the auditor's opinion on internal control are operating effectively may be obtained by following the procedures described in paragraph .12 of AU section 324. These procedures include one or more of the following:

- a. Obtaining a service auditor's report³⁶ on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls. If the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU section 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient appropriate evidence in the same manner described in paragraph 146.
- b. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).
- c. Performing tests of controls at the service organization.

146. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient appropriate evidence to support his or her opinion on internal control. In evaluating whether such a service auditor's report

provides sufficient appropriate evidence, the auditor should assess the following factors:³⁷

- The time period covered by the tests of controls and its relation to the as-of date of management's assertion
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the entity's controls
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls

147. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the entity applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the entity is applying the necessary controls.

148. In determining whether the service auditor's report provides sufficient appropriate evidence to support the auditor's opinion on internal control, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10(a) of AU section 543.

149. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assertion, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the entity's internal control. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

150. As risk increases, the need for the auditor to obtain additional evidence increases. Accordingly, the auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors:

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assertion
- The significance of the activities of the service organization
- Whether there are errors that have been identified in the service organization's processing
- The nature and significance of any changes in the service organization's controls identified by management or the auditor

151. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include

- evaluating procedures performed by management and the results of those procedures.
- contacting the service organization, through the user organization, to obtain specific information.
- requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- visiting the service organization and performing such procedures.

152. The auditor should not refer to the service auditor's report when expressing an opinion on internal control.

Benchmarking of Automated Controls

153. Entirely automated application controls are generally less susceptible to breakdowns due to human failure. This feature may allow the auditor to use a benchmarking strategy.

154. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (that is, last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including the strength of the entity's program change controls.

155. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

156. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are

- the extent to which the application control

36. The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" as described in paragraph .24(b) of AU section 324, *Service Organizations* [AICPA, *Professional Standards*, vol. 1]). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" as described in paragraph .24(a) of AU section 324) does not provide evidence of operating effectiveness.

37. These factors are similar to factors the auditor would consider in determining whether the report provides sufficient appropriate evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in paragraph .16 of AU section 324.

can be matched to a defined program within an application.

- the extent to which the application is stable (that is, there are few changes from period to period).
- the availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

157. Benchmarking automated application controls can be especially effective for entities using purchased software when the possibility of program changes is remote (for example, when the vendor does not allow access or modification to the source code).

158. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors:

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls, and computer operations.
- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.
- The nature and timing of other related tests.
- The consequences of errors associated with the application control that was benchmarked.
- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

Integration With the Financial Statement Audit

Tests of Controls in an Examination of Internal Control

159. The objective of the tests of controls in an examination of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the entity's internal control. The auditor's opinion relates to the effectiveness of the entity's internal control as of a point in time and taken as a whole.

160. To express an opinion on internal control as of a point in time, the auditor should obtain evidence that internal control has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the entity's financial statements. To express an opinion on internal control taken as a whole, the auditor should obtain evidence about the effectiveness of selected controls over all relevant assertions. This entails testing the design and operating effectiveness of controls ordinarily not tested when expressing an

opinion only on the financial statements.

161. When concluding on the effectiveness of internal control for purposes of expressing an opinion on internal control, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

Tests of Controls in an Audit of Financial Statements

162. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. Tests of controls are performed when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.³⁸ Tests of controls are designed to obtain sufficient appropriate audit evidence that the controls are operating effectively throughout the period of reliance.³⁹ However, the auditor is not required to test controls for all relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

163. When concluding on the effectiveness of controls for the purpose of the financial statement audit, the auditor also should evaluate the results of any additional tests of controls performed by the auditor to achieve the objective related to expressing an opinion on the entity's internal control, as discussed in paragraph 160. Consideration of these results may cause the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified deficiencies.

Effect of Tests of Controls on Substantive Procedures

164. If, during the examination of internal control, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

165. Regardless of the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.⁴⁰ Performing procedures to express an opinion on internal control does not diminish this requirement.

Effect of Substantive Procedures on Conclusions About the Operating Effectiveness of Controls

166. In an examination of internal control, the auditor should evaluate the effect of the findings of

the substantive procedures performed in the audit of financial statements on the effectiveness of internal control. This evaluation should include, at a minimum

- the risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- findings with respect to illegal acts and related party transactions.
- indications of management bias in making accounting estimates and in selecting accounting principles.
- misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

167. To obtain evidence about whether a selected control is effective, the control should be tested directly; the operating effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, may affect the auditor's risk assessments in determining the testing necessary to conclude on the operating effectiveness of a control.

EFFECTIVE DATE

168. This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.

169.

EXHIBIT A—ILLUSTRATIVE REPORTS

1. The following illustrate the report elements described in this Statement on Standards for Attestation Engagements (SSAE). These illustrative reports refer to an examination; however, the auditor may refer to the examination of internal control as an audit.¹

2. Report modifications are discussed beginning at paragraph 115 of this SSAE.

Example 1: Unqualified Opinion on Internal Control

3. The following is an illustrative report expressing an unqualified opinion directly on internal control.

Independent Auditor's Report

[Introductory paragraph]

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].² W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal

1. Because the examination of internal control is integrated with the audit of the financial statements and an examination provides the same level of assurance as an audit, the auditor may refer to the examination of internal control as an audit in his or her report or other communications.

2. For example, the following may be used to identify the criteria: "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

(continued on page 130)

control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

[Scope paragraph]

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[Definition paragraph]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effective-

ness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

[Audit of financial statements paragraph]

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [include nature of opinion].

[Signature]

[Date]

Example 2: Unqualified Opinion on Management's Assertion

4. The following is an illustrative report expressing an unqualified opinion on management's assertion.

Independent Auditor's Report

[Introductory paragraph]

We have examined management's assertion, included in the accompanying [title of management report], that W Company maintained effective internal control over financial reporting as of December 31, 20XX based on [identify criteria].³ W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on management's assertion based on our examination.

[Scope paragraph]

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing

and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[Definition paragraph]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

In our opinion, management's assertion that W Company maintained effective internal control over financial reporting as of December 31, 20XX is fairly stated, in all material respects, based on [identify criteria].

[Audit of financial statements paragraph]

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the exam-

(continued on page 132)

3. See footnote 2 of this exhibit.

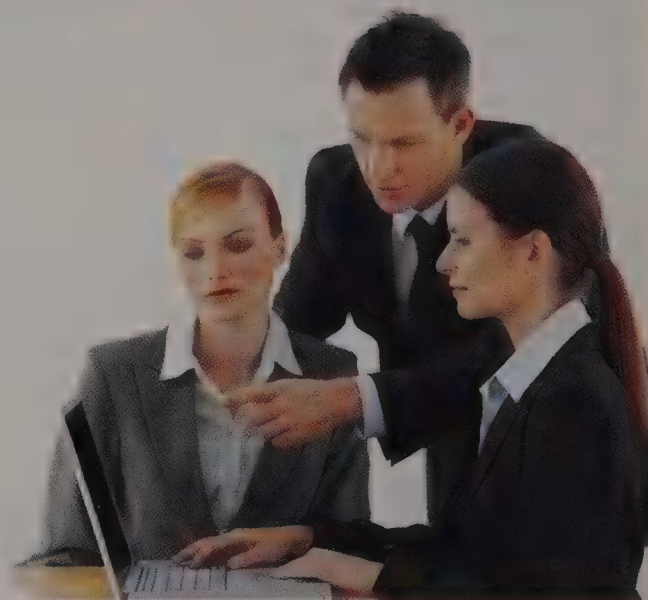
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ination of internal control] expressed [include nature of opinion].

[Signature]

[Date]

Example 3: Adverse Opinion on Internal Control

5. The following is an illustrative report expressing an adverse opinion on internal control. In this example, the opinion on the financial statements is not affected by the adverse opinion on internal control.

Independent Auditor's Report

[Introductory paragraph]

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].⁴ W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

[Scope paragraph]

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[Definition paragraph]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and pro-

cedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Explanatory paragraph]

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. The following material weakness has been identified and included in the accompanying [title of management's report].

[Identify the material weakness described in management's report].⁵

[Opinion paragraph]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

[Audit of financial statements paragraph]

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify finan-

cial statements] of W Company. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect our report dated [date of report, which should be the same as the date of the report on the examination of internal control], which expressed [include nature of opinion].

[Signature]

[Date]

Example 4: Disclaimer of Opinion on Internal Control

6. The following is an illustrative report expressing a disclaimer of opinion on internal control. In this example, the auditor is applying paragraph 119 of this SSAE because a material weakness was identified during the limited procedures performed by the auditor.

Independent Auditor's Report

[Introductory paragraph]

We were engaged to examine W Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].⁶ W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

[Paragraph that describes the substantive reasons for the scope limitation] Accordingly, we were unable to perform auditing procedures necessary to form an opinion on W Company's internal control over financial reporting as of December 31, 20XX.

[Definition paragraph]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to per-

4. See footnote 2 of this exhibit.

5. See paragraphs 111–114 of this Statement on Standards for Attestation Engagements (SSAE) for specific reporting requirements. The auditor's report need only refer to the material weaknesses described in management's report and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report.

6. See footnote 2 of this exhibit.

mit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Explanatory paragraph]

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been identified and included in the accompanying [title of management's report].

[Identify the material weakness described in management's report and include a description of the material weakness, including its nature and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the material weakness.]

[Opinion paragraph]

Because of the limitation on the scope of our audit described in the second paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness W Company's internal control over financial reporting.

[Audit of financial statements paragraph]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report] expressed [include nature of opinion]. We considered the material weakness identified above in determining the nature, timing, and extent of

audit tests applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

[Signature]

[Date]

Example 5: Unqualified Opinion on Internal Control Based, in Part, on the Report of Another Auditor

7. The following is an illustrative report expressing an unqualified opinion on internal control when the auditor decides to refer to the report of another auditor as the basis, in part, for the auditor's own report.

Independent Auditor's Report

[Introductory paragraph]

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].⁷ W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was examined by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[Scope paragraph]

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing

and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other auditors provide a reasonable basis for our opinion.

[Definition paragraph]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

In our opinion, based on our examination and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].⁸

[Audit of financial statements paragraph]

8. As discussed in paragraph 125 of this SSAE, whether the other auditor's opinion is expressed on management's assertion or on internal control does not affect the determination of whether the principal auditor's opinion is expressed on management's assertion or on internal control.

7. See footnote 2 of this exhibit.

(continued on page 134)

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [include nature of opinion].

[Signature]

[Date]

Example 6: Combined Report Expressing an Unqualified Opinion on Internal Control and on the Financial Statements

8. The following is an illustrative combined report expressing an unqualified opinion directly on internal control and on the financial statements. This report refers to the examination of internal control as an audit.⁹

Independent Auditor's Report

[Introductory paragraph]

We have audited the accompanying balance sheet of W Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We also have audited W Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].¹⁰ W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on W Company's internal control over financial reporting based on our audits.

[Scope paragraph]

We conducted our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the

amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[Definition paragraph]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W

Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

[Signature]

[Date]

170.

EXHIBIT B-ILLUSTRATIVE COMMUNICATION OF SIGNIFICANT DEFICIENCIES AND MATERIAL WEAKNESSES

1. The following is an illustrative written communication of significant deficiencies and material weaknesses.

In connection with our audit of W Company's (the "Company") financial statements as of December 31, 20XX and for the year then ended, and our audit of the Company's internal control over financial reporting as of December 31, 20XX ("integrated audit"), the standards established by the American Institute of Certified Public Accountants require that we advise you of the following internal control matters identified during our integrated audit.

Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management's assertion). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness. However, we are responsible for communicating to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit. We are also responsible for communicating to management deficiencies that are of a lesser magnitude than a significant deficiency, unless previously communicated, and inform those charged with governance when such a communication was made.

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course

(continued on page 136)

9. See footnote 1 of this exhibit.

10. See footnote 2 of this exhibit.

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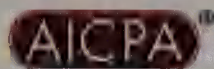


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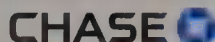
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of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. [A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis. We believe the following deficiencies constitute material weaknesses:]

[Describe the material weaknesses that were identified during the integrated audit. The auditor may separately identify those material weaknesses that exist as of the date of management's assertion by referring to the auditor's report.]

[A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies:]

[Describe the significant deficiencies that were identified during the integrated audit.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

171.

EXHIBIT C—REPORTING UNDER SECTION 112 OF THE FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT (FDICIA)

1. In Financial Institution Letter (FIL) 86-94, *Additional Guidance Concerning Annual Audits, Audit Committees and Reporting Requirements*, issued December 23, 1994, the Federal Deposit Insurance Corporation (FDIC) provided guidance on the meaning of the term *financial reporting* for purposes of compliance by insured depository institutions (IDIs) with Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act, 12 U.S.C. 1831m), and its implementing regulation, 12 CFR Part 363. The FDIC indicated that financial reporting, at a minimum, includes financial statements prepared in accordance with generally accepted accounting principles (GAAP) and the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income [Call Report]). Accordingly, to comply with FDICIA and Part 363, management of the IDI (or a parent hold-

ing company)¹ and the auditor should identify and test controls over the preparation of GAAP-based financial statements as well as the schedules equivalent to the basic financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report. Further, both management and the auditor should include in their report on the IDI's (or its holding company's) internal control a specific description indicating that the scope of internal control included controls over the preparation of the IDI's (or its holding company's) GAAP-based financial statements as well as the schedules equivalent to the basic financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report.

2. In accordance with paragraph 107 of this SSAE, the auditor's report should include a definition of internal control (the auditor should use the same description of the entity's internal control as management uses in its report). The following is an illustrative definition paragraph that may be used when an IDI that is a bank (which is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) elects to report on controls for FDICIA purposes at the bank holding company level:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our examination were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our examination of [Holding Company's] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C).² An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2)

1. See Financial Institution Letter (FIL) 86-94 for further discussion of reporting at the holding company level for Federal Deposit Insurance Corporation Improvement Act purposes and the application of holding company reporting as it relates to controls over the preparation of "regulatory reports."

2. This sentence would be modified if the insured depository institution (IDI) reports at the institution level rather than at the bank holding company level to refer to the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income or the Office of Thrift Supervision Instructions for Thrift Financial Reports instead of to the Form FR Y-9C. This sentence would also be modified if the IDI reports at a holding company level and employs another approach to reporting on controls over the preparation of regulatory reports as permitted by FIL 86-94.

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

172.

EXHIBIT D—ILLUSTRATIVE MANAGEMENT REPORT

1. The following is an illustrative management report containing the reporting elements described in paragraph 95 of this SSAE:

Management's Report on Internal Control Over Financial Reporting

W Company's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Management is responsible for establishing and maintaining effective internal control over financial reporting. Management assessed the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control—Integrated*

Framework. Based on that assessment, management concluded that, as of December 31, 20XX, W Company's internal control over financial reporting is effective based on the criteria established in *Internal Control—Integrated Framework*.

W Company

Report signers, if applicable
Date

This statement, An Examination of an Entity's Internal Control Over Financial Reporting That is Integrated With an Audit of Its Financial Statements, was unanimously adopted by the assenting votes of the 19 members of the board.

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The AICPA gratefully acknowledges the work of Maria C. Manasses in the development of this Statement on Standards for Attestation Engagements.

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Note: Statements on Standards for Attestation Engagements are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on attest matters. Rule 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 202), of the Institute's Code of Professional Conduct requires compliance with these standards.

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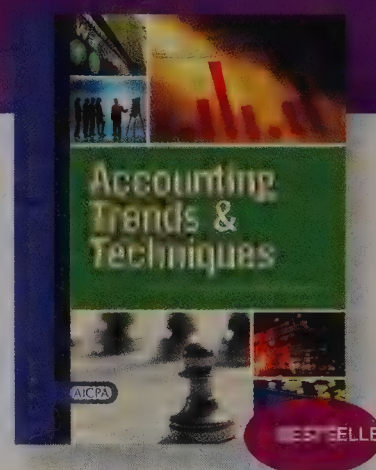
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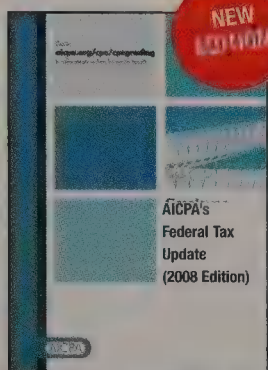
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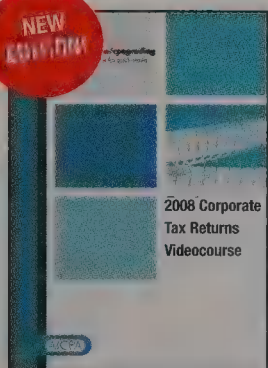
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- Advise clients or employees on new developments and tax-saving ideas in corporate income taxation

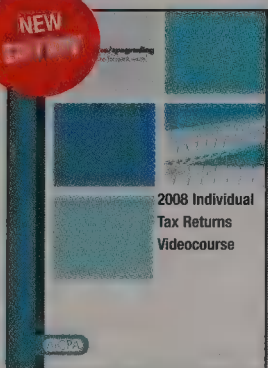
Prerequisite: Knowledge of corporate income taxation and Forms 1120 and 1120S preparation.

Level: Update

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Prerequisite: Knowledge of individual income taxation and Form 1040 preparation.

Please Note: The Text contains advance preparation readings and exercises. The Manual contains outline and review items on the video content.

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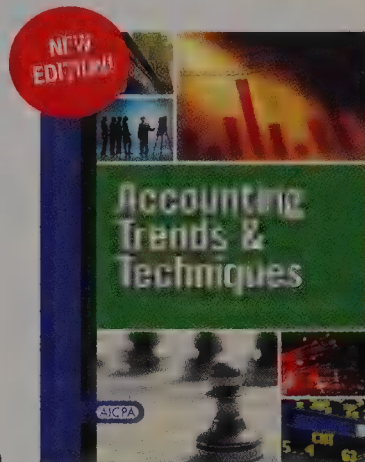
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 - FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
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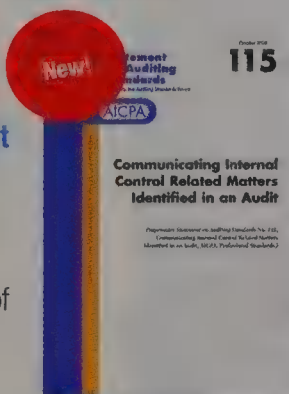


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SAS No. 115: Communicating Internal Control Related Matters Identified in an Audit

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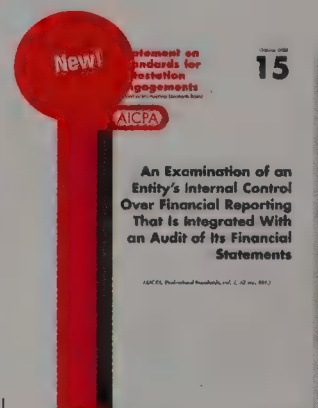


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SSAE No. 15: An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of its Financial Statements

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THE LAST WORD

How can some people argue against safety for schoolchildren?

My daughter, Ashley, was on a motor coach with her teammates of the West Brook High School girls varsity soccer team, here in Beaumont, Texas, on March 29, 2006, on their way to a playoff game in Houston. In the middle of a rainstorm, the bus left the road and overturned. My daughter was ejected through the motor coach window, causing her death. Her teammate Alicia Bonura was also killed. Two other teammates were trapped under the bus for over an hour.

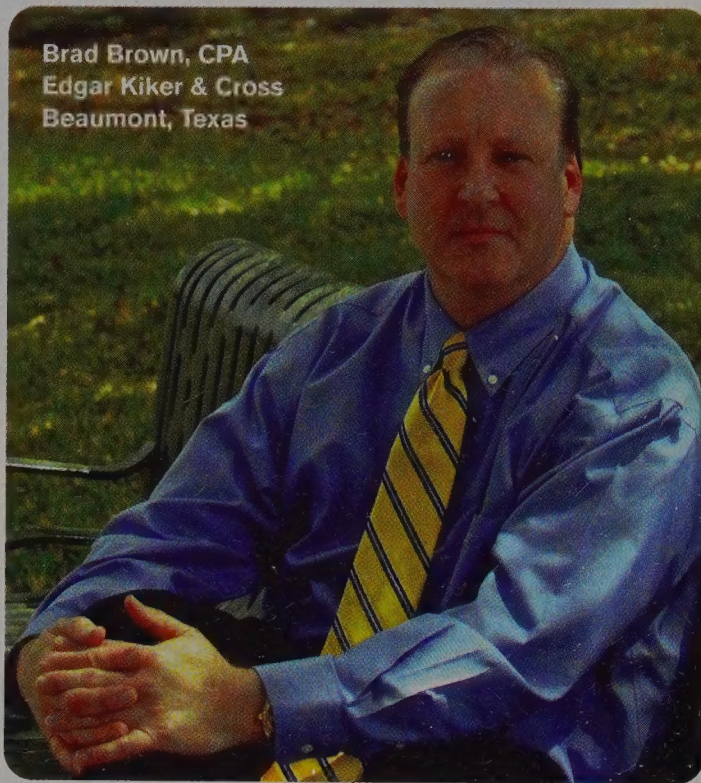
After the funerals, the mourning, the surgeries, we began asking what any parent would: How did this happen, why did it happen, and how can we prevent this from ever happening again? We learned that many schools use chartered motor coaches for school activities, and those motor coaches lack some of the safety features required in cars, including lap and shoulder belts, safety glass in those large windows and roof crush protection. Most school buses don't have lap and shoulder belts, either.

We formed West Brook Bus Crash Families to advocate for safer bus travel for schoolchildren. Seat belts are a safety measure that we all expect in our own vehicles, and we're able to say truthfully that about the only place a child learns not to wear a lap and shoulder belt is at school.

The Beaumont Independent School District became the first in Texas to require lap and shoulder belts on all new school buses. It also added 30 new school buses with seat belts, which enabled them to eliminate the use of motor coaches for all school activities.

My training as a CPA has helped as our group works to overcome resistance among directors of student transportation and their cost arguments against seat belts on school buses. Digging into their numbers, we realized the assumptions they were using were not based on fact or experience and were 15 times actual cost. As an active member of the Texas Society of CPAs, I had developed relationships with our Texas state legislators, advocating for issues, and had learned how the process works. Just as our daughters were

Brad Brown, CPA
Edgar Kiker & Cross
Beaumont, Texas



members of the same team, we parents all worked together for the cause. One injured girl's father, Steve Forman, is an attorney with engineering experience and railroad clients, so he knows the transportation codes and has been effective at shaping our arguments.

My firm has been supportive. I'm a shareholder with Edgar Kiker & Cross, the firm that gave me an internship 28 years ago and where I've been ever since. As it happens, the Texas legislative session begins in January and ends in May, which like any local firm, is our busiest time. They are gracious to allow me to spend time away in campaign mode.

Texas Gov. Rick Perry signed "Ashley and Alicia's Bill" at West Brook High School, requiring all Texas school buses purchased after Sept. 1, 2010, to be equipped with shoulder and lap belts.

Our next steps took our fight to the nation. Texas Sen. Kay Bailey Hutchison is a co-sponsor, along with Ohio Sen. Sherrod Brown, of S 2326, the Motorcoach Enhanced Safety Act, which will require common-sense safety measures on motor coaches, including seat belts, safety glass and improved firefighting equipment. Our Rep. Ted Poe is a co-sponsor, along with Rep. John Lewis of Georgia, of HR 6747, the House companion legislation.

The loss of a child leaves a gaping hole in families, and we know it will never be the same and that we'll always be imprinted by the experience. But it doesn't have to define who we are. What defines us is how we respond. And I found that the work toward this legislative remedy was a redeeming one for me. It allowed me to find something good out of something so horrible, and somehow, I feel, it provides some memorial to my precious daughter. If I can just prevent other parents from going through what I've been through by my effort—our effort—that would be a good thing.

—As told to Paul Bonner

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